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Supreme Court, U.S.
FILED

MAR 28 2011

OFFICE OF THE CLERK

No. 10- 101188

IN THE

Supreme Court of the United States

NORMAN W. ADAIR AND BARBARA L. ADAIR,
TERRY D. AND GLORIA K. OWENS, AND
HOYT W. AND BARBARA D. YOUNG,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. IS THE INTERNAL REVENUE SERVICE EMPOWERED TO COLLECT STATUTORY INTEREST ON PERIODS OF DELAY WHICH HAS ACCRUED AS A RESULT OF ONGOING FRAUD PERPETRATED BY ITS ATTORNEYS?

2. DOES APPLICATION OF THE EVIDENTIARY INFERENCE AGAINST SPOILIATION OF EVIDENCE APPLIED BY THE FEDERAL COURTS REQUIRE PROOF OF BAD FAITH?

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Petitioners, Norman W. Adair, Barbara L. Adair, Hoyt W. Young, Barbara D. Young, Terry D. Owens, and Gloria K. Owens, respectfully pray that a Writ of Certiorari issue to review the Decision of the United States Court of Appeals for the Ninth Circuit which affirmed the Decision and Opinion of the United States Tax Court which appears at 91 T.C.M. (CCH 1086) and a Supplemental Opinion and Decision of the Tax Court which appears at 92 T.C.M. (CCH 245).

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Ninth Circuit which was reported is set forth in Appendix A.

The original Memorandum Opinion of the United States Tax Court which is not reported is set forth in Appendix B.

The Supplemental Memorandum Opinion of the United States Tax Court, which is not reported is set forth in Appendix C.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on September 1, 2010. Petitioners' timely filed Motion for Rehearing En Banc was denied by the Ninth Circuit Court of Appeals on December 28, 2010. (Appendix E)

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are 26 U.S.C. § 6404 set forth in Appendix F and 26 U.S.C. § 6601 set forth in Appendix G.

STATEMENT OF THE CASE

1. This "test" case tax litigation involved approximately 1,800 taxpayers who claimed tax deductions as the result of participation in a stock purchase tax shelter promoted by deceased Honolulu businessman, Henry Kersting. See *Dixon v. Commissioner*, 62 T.C.M. (CCH 1440) (1991) for an early history. After numerous audits the Commissioner of Internal Revenue ("COMMISSIONER") disallowed the deductions claimed by the participants on their personal income tax returns. More than 1,300 taxpayers participating in the program filed Petitions in the Tax Court contesting the disallowance. Appendix C, P. 172a. Ostensibly to avoid lengthy delay and the costs associated with the multiplicity of suits, the Commissioner and the taxpayers entered into a written stipulation contract agreeing to employ a "test-case" procedure under which the Owens and Young Petitioners and a few other tax-shelter participants selected as test cases would litigate various "representative" deductions in the Tax Court and the remainder of the participating taxpayers signing the stipulation would agree to be bound by the Tax Court's opinion in the test cases. Appendix B, PP. 56a-57a, 114a.

Prior to the date the test-case trials began, Kenneth McWade, an Internal Revenue Service attorney assigned

to try the test-cases, and William Sims, the District Counsel of Hawaii, and his immediate supervisor, entered into secret contingent settlement agreements with test-case taxpayers, John and Maydee Thompson and John and Maria Cravens. Appendix B, P. 44a. Neither of these settlement agreements were disclosed to the Tax Court, test-case counsel, or any of the other participating taxpayers. Appendix B, P. 38a. The Tax Court specifically found that in the original Honolulu trial of the test-cases, McWade acted in a deceptive manner designed to prevent the Tax Court and the other taxpayers from uncovering the settlement agreements. Appendix A, P. 9a-10a.

At the conclusion of the original Honolulu trial and after briefing, the Tax Court disallowed the interest deductions and other deductions claimed by the test-case Petitioners. *Dixon*, 62 T.C.M. (CCH) at 1440. Based in part on Thompson's testimony, the Tax Court found that the indebtedness generated by the tax shelter stock purchase transactions was not genuine, that no actual payment of interest had occurred, and that the interest deductions which the participating taxpayers claimed should be disallowed. *Dixon*, 62 T.C.M. (CCH) at 1506.

The Commissioner claimed, and the Tax Court found, that Sims and McWade's superiors in the IRS Office of Chief Counsel did not become aware of the settlement agreement until after the Tax Court had tried the test-cases, issued its Opinion, and entered its decisions. Appendix B, P. 38a. Although the Commissioner did direct his attorneys to file Motions to Vacate in three of the test-cases -- including the one involving the Thompsons -- which advised the Tax Court that Sims and McWade had entered into secret contingent settlement agreements

with the Thompson and Cravens taxpayers that had not been disclosed to the Court, test-case counsel, or the other taxpayers, the Commissioner failed to appeal when the Tax Court granted his Motion to Vacate, but then reinstated the Decisions that were based on Sims and McWade's fraudulent settlements with the Thompson and Cravens Petitioners. Appendix B, P. 39a.

2. The test-case Petitioners that had no fraudulent settlements with the Commissioner's attorneys appealed to the Ninth Circuit in *DuFresne v. Commissioner*, 26 F.3d 105 (9th Cir. 1994 *per curiam*), cert. denied, 514 U.S. 1036 (1995). The Court of Appeals vacated the Tax Court's decision in *Dixon*, remanded the case to the Tax Court to determine whether the fraud committed by the Commissioner's attorneys constituted a "structural defect" or mere harmless error, but took no further action. The remaining taxpayers filed a Petition for Writ of Certiorari with this Court which sought a ruling that under the terms of the test-case stipulation with the Commissioner, the remaining test-case Petitioners and all the other participating taxpayers signing the stipulation contract were entitled to the same pecuniary benefits as those extended to Thompson and Cravens in the fraudulent settlements. After denial of certiorari review and remand to the Tax Court, the Tax Court concluded once more that innocent taxpayers were not entitled to any relief as a result of the Commissioner's attorneys' fraud and that the fraud was not a "structural defect" but, instead, harmless error. *Dixon v. Commissioner*, 77 T.C.M. (CCH) at 1630, 1700, 1712, 1716 (1999). Failing to address the effect of the fraud on public confidence in the integrity of the Courts, the Tax Court claimed that the test-case Petitioners had been afforded a fair trial despite the Government fraud

and that the misconduct of the Commissioner's attorneys was not material to the outcome of the case(s). *Dixon v. Commissioner*, 77 T.C.M. (CCH) at 1712, 1716.

3. After receiving this ruling, the test-case Petitioners and others who had been allowed to participate in the Tax Court proceedings appealed once more to the Ninth Circuit. In *Dixon v. Commissioner*, 316 F.3d 1041 (9th Cir. 2003) the Court of Appeals again reversed the Tax Court. As a basis for its reversal, the Ninth Circuit, in speaking to the Commissioner's attorneys' fraud described the harmful error as follows:

> This harm is noteworthy not only because it defiled the sanctity of the Court and the confidence of all future litigants, but also because it violated the rights of the test-case Petitioners.

Appendix D, P. 199a.

While the Court rejected some Petitioners' demands for elimination of all tax deficiences, the Court of Appeals remanded the case to the Tax Court with specific instructions to "enter judgment in favor of Appellants and all other taxpayers properly before the (Tax) Court on terms equivalent to those provided in the secret settlement agreement between Thompson and the IRS. Appendix B, P. 46a. The Court admonished the Tax Court to use its discretion to:

> Fashion...such judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided for in the Thompson settlement.

316 F.3d at 1047, n. 11. After an extensive evidentiary hearing and reconsideration in light of the Ninth Circuit's mandate, the Tax Court determined that bribed witness Thompson had received a 63% reduction in his deficiencies which were before the Court. Appendix B, P. 156-158a. The Tax Court also eliminated outstanding penalties and additions to tax, but imposed interest on the remaining amount of the deficiencies from 1986, the year the Commissioner's attorney's fraudulent scheme began until 1992. Appendix B, P. 107a-109a. Faced with the taxpayers' claims that the interest charges on the remaining deficiencies under 26 U.S.C. § 6601 accrued during the periods of delay caused by the fraudulent scheme, the Commissioner agreed to suspend the running of interest from June, 1992 until ninety days after the Tax Court entered its Decision on remand. Appendix B, P. 108a. Interest began to accrue once more on September 13, 2007, the date ninety days after the Tax Court entered its final decisions.

4. As a rationale for allowing the Commissioner to charge and collect interest on the deficiencies which accrued during the fraudulent delays resulting from the Commissioner's attorneys' scheme, the Tax Court claimed that Thompson had received no interest relief during this time because he had made advance payments of estimated tax, a step that any of the other affected taxpayers could have taken to stop the interest from accruing. Appendix B, at P. 90a.

Despite the Commissioner's admission that his attorneys and agents had failed to preserve Thompson's administrative tax files for open years after the Commissioner's attorneys' fraudulent scheme was implemented, the Tax Court refused to shift the burden

of proof concerning the amount and nature of Thompson's receipts of fraudulent benefits onto the Commissioner. Appendix B, P. 80a.

Petitioners appealed the Tax Court's imposition of fraudulent interest charges and refusal to remedy the Government's spoiliation of evidence to the Ninth Circuit which affirmed the Tax Court's decision in all respects. Appendix A, P. 36a.

The Commissioner has conceded in filings in this Court, by the United States, that the Ninth Circuit affirmed the Tax Court's decision based on its determination that the affected taxpayers who were test-case Petitioners or had signed the stipulation to be bound by the test-case results would be in the same position as Thompson if: (1) Petitioners' tax liability was reduced by 63.37%; and (2) Petitioners remained liable for the underpayment in interest required by 26 U.S.C. § 6601 on their remaining tax deficiencies excluding the interest that the Com missioner had voluntarily agreed to abate. Appendix B, P. 161a.

The Court of Appeals addressed both arguments which are presented in this Petition. That the interest the Government seeks to collect on deficiencies from 1986 through 1992 accrued during a period of delay caused by the Commissioner's attorneys' fraud is admitted on the face of the record and found, as a fact in the Opinion of the Court of Appeals. Appendix B, P. 167a. The Commissioner's agents' destruction of Thompson's administrative file and tax records for years in which he could have received surreptitious benefits from the Government for his testimony, was also conceded. Appendix A, P. 28a.

This Petition presents the questions of whether IRS is empowered to charge, and Federal Courts should enforce, liability for interest on tax deficiencies accrued during periods of delay caused by fraudulent conduct of the Commissioner's attorneys and whether parties in Federal Court, like these Petitioners, and the taxpayers affected by the Government fraud in this case, must prove bad faith destruction of evidence before obtaining the benefits of the evidentiary inferences against the spoiliators of evidence imposed by this Court under federal common law.

REASONS FOR GRANTING THE PETITION

1. THE FEDERAL COMMON LAW AND EQUITABLE DOCTRINES, AND DECISIONS OF THIS COURT PROHIBIT COLLECTION OF STATUTORY INTEREST WHICH ACCRUES AS THE RESULT OF GOVERNMENT FRAUD. (*Litchfield v. County of Webster*, 101 U.S. 773, 779 (1879).)

The Court of Appeals found in its prior *Dixon* Opinion that "...the actions of McWade and Sims amounted to a fraud on both the taxpayers and the Tax Court..." Appendix A, P. 13a.

This case presents the question of whether Congress displaced the traditional equity and common law powers of this Court to remedy fraud in the assessment and collection of interest on tax deficiencies and whether, indeed, Congress ever intended to limit this Court's traditional powers. I.R.C. § 6601. The Tax Court and the Court of Appeals refused to rule squarely on the issue, but left the question, instead, to the discretion of

the Commissioner who opted to abate the interest which accrued from 1992 through September 13, 2007 and retain interest accrued from 1986 through 1991.

The Tax Court and Court of Appeals decisions have the effect of levying a charge for interest on tax deficiencies against these Petitioners and various other affected taxpayers which accrued as a byproduct of the delay in the resolution of their cases by the Tax Court brought about by the fraudulent scheme perpetrated by the Commissioner's attorneys.

Contrary to the argument presented by the Commissioner in his recent Brief of the United States in Opposition filed in No. 10-749 previously pending in this Court, these Petitioners never argued that the interest imposed due to that delay should be abated as a sanction. The issue is far more serious than that and has national implications to our system of Justice and the integrity of the Federal Courts. The processes of the Federal Courts must not be successfully perverted by the Executive Branch or its agents to put over a fraud on the taxpayers and thereby undermine public confidence in the integrity of the Courts. The Ninth Circuit Court of Appeals Opinion in *Dixon v. C.I.R.*, 316 F.3d 1041 (9th Cir. 2003) recognized that fact. Currently, the Commissioner and the Government, who are poised to collect some of the interest charges which accrued during the approximate twenty-five year litigation period of this case stand to profit from the fraud committed by their agents. This fraudulent benefit can not be allowed to stand. No one, not even the Government or its agencies, must be allowed to profit from their own wrong.

Is this Court shackled by the statutory dictates of Congress from providing any legal or equitable relief to these Petitioners or the other affected taxpayers?

One of the duties and burdens of this Court when it inherited the power of the King's Chancellor, and assumed the role of the Conscience of the Judicial Branch, was to provide relief from fraud where there is no adequate remedy at law or where the dictates of the common law demand it.

A laborious reading of every case which addresses the issue of equitable relief from tax penalties and interest generated by the misconduct of governmental taxing authority(ies) reveals that by 1879 penalties were considered interest and interest considered penalties, and a bill in equity lay to enjoin the collection of both.

The Federal Courts which have applied equitable principles to the cases that came before them and are subject to their jurisdiction act within the powers conferred on them by the Constitution. Over a 120 years ago this Court in *Litchfield v. County of Webster*, 101 U.S. 773, 779 (1879) rejected the Tax Court and Court of Appeals' holding in this case that the legal requirements for tax collection of statutory interest to feed the Public Fisc trump any equitable power to abate interest on delay begat by Government misconduct. Granting relief from the misconduct, this Court observed:

> It is an elementary principle in equity jurisprudence, that if money is lying dead to meet an obligation, and delay in its payment is caused by fault of him to whom it is to be paid, interest during the delay is not recoverable.

> Here, the delay was caused by the improper interference of the State and the United States with the title. Litchfield himself has been guilty of no fraud or willful default.

This Court is bound by its own precedent and the Tax Court and Court of Appeals' imposition of statutory interest on fraudulently-generated periods of delay must be reversed. This Court's decision in *Litchfield* bars the collection of such interest under the rule of stare decisis.

It has been argued laboriously and long, but erroneously, in the Tax Court and Court of Appeals that equitable relief may not be granted from the statutory imposition of interest even if such interest is generated by Government fraud. *Litchfield* is still viable after over a hundred years and dispels any notions of statutory superiority over the traditional legal and equitable powers of the Judicial Branch.

As this Court admonished in *Califano v. Yamasaki*, 442 U.S. 682, 705 (1979):

> Only the clearest Congressional 'command' displaces Courts' traditional equity powers...

None has been shown, rather the statutory history of relief from penalties and interest under the Code lends further support for a reversal of the Tax Court and Court of Appeals' imposition of interest on the deficiencies of the "affected taxpayers" while the fraud was in progress.

In *Greene-Thapedi v. Commissioner*, 126 T.C. 1 (2006), fn. 21, the full Tax Court examined the history of interest relief under the tax statutes. Tracking I.R.C.

§ 6404(e) which allows abatement of interest, the majority Tax Court Opinion observed:

> Petitioner has not alleged, and the record does not suggest, that she qualifies for abatement of interest under the applicable version of Section 6404(e), which would require unreasonable error or delay resulting from a 'ministerial act.'

Citing *Urbano v. Commissioner*, 122 T.C. 384, 390 (2004) n. 4.

The Tax Court noted that in 1996, the legislative amendment to I.R.C. § 6404(e) broadened the scope of relief available under the statute to include, for tax years beginning in 1996, unreasonable error or delay resulting from 'managerial and ministerial' acts. Thus, the subsequent statutory history establishes a Congressional intent consistent with the equitable relief granted by this Court in *Litchfield* rather than an intent to limit it.

The Panel Opinion in *Hongsermeir*, cites *Grauvogel v. C.I.R.*, 768 F.2d 1087, 1090 (9th Cir.) for the proposition that imposition of statutory interest is mandatory and the Federal Courts can give no relief in the event of fraud. Of the eight other federal citations which cite *Grauvogel*, only one addresses an attempt to obtain relief from interest charges on income tax deficiencies. See *Suffness v. U.S.*, 974 F.2d 608, 612 (5th Cir. 1992) (**Lawful delay** in fixing amount of tax liability does not prevent interest charges from running.)

The Court of Appeals apparently concluded that the income tax statutes mandating interest charges on unpaid

tax deficien cies stripped the Federal Courts of any legal or equitable power to grant relief.[1]

Are the Federal Courts including this Court powerless to grant relief from the fraudulently-generated interest? Since its inception this Court has followed the precept of federal common law and equitable jurisprudence set out in *Glus v. Brooklyn Eastern Terminal*, 359 U.S. 231, 232 (1959).

> To decide the case we need look no further than the maxim that no man may take advantage of his own wrong. Deeply rooted in our jurisprudence this principle has been applied in many diverse classes of cases by both law and equity courts[fn6] and has frequently been employed to bar inequitable reliance on statutes of limitations.[fn7]

How did it come to be that this phrase became both a legal as well as an equitable maxim of the federal common law over which this Court presides? The answer can be found in *Swayze and Wife v. Berke, et al.*, 37 U.S. 11, 13 (1838) in which the principle, inherited from the Courts and Chancellor of England, was explained thusly:

> On the trial of the cause, the counsel requested the district judge to charge the jury, "in

1. The Tax Court's decision below, imposed interest on the Appellants' deficiencies from the date it found the fraudulent scheme began in 1986 until 1992. The "admitted" Government fraud caused this period of delay and therefore the interest generated during this period was the product of fraud.

> matters of fraud, courts of law and chancery have a concurrent jurisdiction. It is, therefore, within the province of the jury, to inquire whether the conduct and proceedings of Oliver Ormsby, whereby the legal title to the property in dispute became vested in himself, for his exclusive use and benefit, were in fraud of the rights of his cotenant, Mary Swayze; and if they were, the verdict ought to be for the plaintiffs."

Thus, in matters of fraud Federal Courts may not refuse relief based on the equitable maxim that "equity follows the law" and statutory requirements, such as collection of interest on tax deficiencies do not hold sway over the Federal Courts traditional equitable powers. The fraud here must be remedied both at law as well as in equity.

But then did Congressional passage of the interest statutes requiring the levy and collection of interest charge on tax deficiencies override this principle of the common law? The answer is no since the legal system we inherited from England upon the advent of Article III Judges and the ratification of the Constitution has ever held the precept that statutes in derogation of the common law must be strictly construed.

But what is the effect of strict construction in this case? The answer can be found in this Court's more recent cases such as *United States v. Texas*, 507 U.S. 529 (1993). Preserving the Federal Government's common law right to collect interest on debts owed by the State, this Court answered that question as follows:

> Just as longstanding is the principle that "[s]tatutes which invade the common law...are to be read with familiar principles, except when a statutory purpose to the contrary is evident." *Isbrandtsen Co. v. Johnson*, 343 U.S. 779, 783 (1952); *Astoria Federal Savings & Loan Assn. v. Solimino*, 501 U.S. 104, 108 (1991). In such cases, Congress does not write upon a clean slate. *Astoria*, supra, at 108. In order to abrogate a common law principle, the statute must "speak directly" to the question addressed by the common law. *Mobil Oil Corp. v. Higginbotham*, 436 U.S. 618, 625 (1978); *Milwaukee v. Illinois*, 451 U.S. 304, 315 (1981).

Unless the statute passed by Congress "speaks directly to" the Federal common law right, it does not abrogate it. Here, just as in *Texas*, the tax statutes imposing interest on unpaid tax deficiencies do not "speak directly" to relief from interest engendered by fraud either under the Federal common law or the Federal Courts' traditional equitable powers. This Courts' decision in *Texas* once more reaffirmed the principle that Federal common law rights which are not abrogated by specific statutory directive survive, remain viable, and must be enforced.

This Court's power to remedy the fraud it finds before it now in the face of statutory arguments or interpretations to the contrary is further buttressed by the principle that an equitable construction must be given to the law. See *Crawford v. Washington*, 541 U.S. 36, 47 (2004).

An equitable construction of the interest statutes, in turn, requires application of Federal common law and

equitabale principles prohibiting the Government from profiting from the wrong perpetrated by its own agents. Further supporting the grant of relief requested in this Petition is the additional legal and equitable maxim that fraud vitiates everything it touches and that, therefore, the statutory right to collect interest generated by fraud is vitiated and must give way. See *Boyce's Executors v. Grundy*, 28 U.S. 210, 220 (1830). Proper response to the Commissioner's claim that the taxpayers in this case should be grateful for the half of loaf interest relief he accorded them can be found in *Boyce's Executors* in which this Court explained:

> It has been further argued, that the misrepresentation, if at all established, was but of a personal character, and susceptible of compensation or indemnity, to be assessed by a jury. On this there may be made several remarks; and first, that if the facts made out such a case, yet the law, which abhors fraud, does not incline to permit it to purchase indulgence, dispensation, or absolution

The Commissioner is no legis emperator whose role is to mete out Justice in half measures while the Federal Courts shirk their responsibility to give Justice its full measure. The Commissioner did not purchase any dispensation by shouldering the Tax Court and Court of Appeals' burden in giving the taxpayers a half-measure of relief. His act, unwisely lauded by the Tax Court and the Court of Appeals, leaves the impression to the general public, that crime pays and that the fraud your agents commit will be profitable even if you get caught!

Created in fraud Petitioners' obligation to pay statutory interest is vitiated and no longer has any legal force or effect. This is so because "fraud vitiates every act whether public or private, contracts, deeds, and judgments." *The Amiable Isabella*, 19 U.S. 1, 52 (1820).

As part of their traditional equity powers Federal Courts have general jurisdiction to remedy fraud. *United States v. Bell Telephone Co.*, 128 U.S. 315, 370 (1888).

Nor is the Commissioner's decision to grant half a loaf of relief for the fraud his attorneys worked beyond review. His decision, like all administrative decisions under the standards of this Court's rules of administrative review, must not be:

> Arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.

See *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 403 (1971).

Clearly, the Commissioner's decision to retain a portion of the fraudulent benefits his attorneys garnered is "not in accordance with the law" under the above standards irrespective of whether the tests for administrative review under the Administrative Procedure Act apply to the Internal Revenue Service. Here, both law and equity require complete vitiation of the interest charges worked by the Commissioner's attorneys' fraud. Thus, there is "law to apply" and the Commissioner has no discretion to withhold complete relief. See *Citizens* at P. 410.

By deferring their responsibilites to provide interest relief to the Commissioner , both the Tax Court and the Court of Appeals violated this Court's rule in *Rothensies v. Electric Battery Co.*, 329 U.S. 296, 299 (1946) which requires a Petitioner's case to be:

> Examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.

Other than the application of the interest statutes, this case is no different from *United States v. State Bank*, 96 U.S. 30, 36 (1877) in which this Court made the following observations concerning the Government's effort to benefit from its own fraud:

> In these cases, and many others that might be cited, the rules of law applicable to individuals were applied to the United States. Here the basis of the liability insisted upon is an implied contract by which they might well become bound in virtue of their corporate character. Their sovereignty is in no wise involved.
>
> But surely it ought to require neither argument nor authority to support the proposition, that, where the money or property of an innocent person has gone into the coffers of the nation by means of a fraud to which its agent was a party, such money or property cannot be held by the United States against the claim of the wronged and injured party

Despite this Court's observation in *State Bank*, Petitioners and the other affected taxpayers have had to argue loud and long that the Commissioner may not retain his "ill-gotten gains" in the form of fraudulently-generated interest charges and have still not received complete Justice. See also *Bull v. United States*, 295 U.S. 247 (1935).

> Retention by the Government of money wrongfully exacted in taxes, is immoral and amounts to a fraud on the taxpayer's rights.

To allow the Commissioner to retain the fraudulent interest benefits resulting from his attorneys' misconduct would be to give the test-case stipulation contract between the Government and the taxpayers an impermissible construction which would allow the Government to commit a fraud. See *Wm. Cramp and Sons v. United States*, 216 U.S. 494, 496 (1910).

Despite any claims to the contrary, the Tax Court had the necessary equitable jurisdiction to give full and complete relief in the matter before it. See *Kelley v. C.I.R.*, 45 F.3d 348,351 (9th Cir. 1995). Having provided the Government equitable relief when necessary to protect the revenue in the numerous decisions cataloged in *Kelley*, the Tax Court and the Court of Appeals are hardly in position to argue that the Petitioners and affected taxpayers are not entitled to the same protection.

Finally, refusal to grant relief in this case from the Tax Court and Court of Appeals' decision allowing the Government to retain the fraudulent benefits obtained by its agents violates the public policy which this Court

in *United States v. Mississippi Valley Co.*, 364 U.S. 520 (1961) described thusly:

> The question is whether the Government may disaffirm a contract which is infected by an illegal conflict of interest. As we have indicated, the public policy embodied in Section 434 requires nonenforcement, and this is true even though the conflict of interest was caused or condoned by high government officials.

This Court's approval of the Government's rejection of a contract tainted with fraudulent conflict of interest is in keeping with the admonition that prevention and correction of fraud is a matter of high public policy. See *United States v. Acme Process Equipment Co.*, 385 U.S. 138, 87 S.Ct. 350, 17 L.Ed.2d 249 (1966). Also *PSI Corp. v. United States*, 655 F.2d 1072, 1077 (Ct. Cl. 1981). All of the above principles support the continuing viability of *Litchfield* and require its application in this case.

To the anticipated invocation by the Government of United States of *Johnston*, 268 U.S. 220, 227 (1925) for the proposition:

> We do not grant...certiorari to review evidence and discuss specific facts.

Petitioners and the affected taxpayers respond that there are no factual issues concerning the Government's fraud -- the fraud as well as the destruction of evidence are admitted on the face of the record.

To the anticipated Government argument that certiorari should not be granted since the Government fraud demonstrated on the record of this case is not likely to recur, the Petitioners and affected taxpayers respond that certiorari should be granted to insure that it never happens again.

The Tax Court's decision and the Court of Appeals Opinion and judgment allowing the Commissioner to retain fraudulent benefits should be reversed and the cause rendered in Petitioners' favor that Petitioners' owe no interest on the deficiencies during the period of time the Commissioner's attorneys' fraud was in progress.

2. APPLICATION OF THE EVIDENTIARY INFERENCE AGAINST DESPOILIATION OF EVIDENCE IMPOSED BY THE FEDERAL COURTS DOES NOT REQUIRE PROOF OF BAD FAITH.

In *Glover v. B.I.C. Corp.*, 6 F.3d 1318, 1319 (9th Cir. 1993), the Ninth Circuit, faced with the question of the proper application of adverse inference due to spoiliation of evidence held:

> Short of excluding the disputed evidence, a Trial Court also has the broad discretionary power to permit a jury to draw an adverse inference from the destruction or spoiliation against the party or witness responsible for that behaviour. *Akiona v. United States*, 938 F.2d 158 (9th Cir. 1991). As *Unigard* correctly notes, however, a finding of 'bad faith' is not a prerequisite to this corrective procedure. 982

> F.2d at 368-70 and n.2. Surely a finding of bad faith will suffice, but so will simple notice of 'potential relevance to litigation.'

Glover allowed Federal Courts in the Ninth Circuit to impose an adverse inference against a spoiliator of evidence, like the Government in this case, without a finding of bad faith. Proof that the spoiliator had notice of the potential relevance of the evidence destroyed is all that is necessary to support application of the inference.

The Court of Appeals Opinion in *Hongsermier* ignored the IRS' admitted destruction of evidence because Petitioners failed to prove that IRS acted in bad faith, and that the destroyed evidence would "...prove their (Petitioners') assertions.... Appendix A, P. 28a. The Court of Appeals Opinion at issue here also purports to excuse the Government's inexcusable destruction of evidence by pointing out that it occurred:

> At a time when tax filings were made on paper rather than electronically.

Appendix A, P. 28a.

The Court of Appeals Opinion in *Hongsermeier* violates its own Circuit's precedent. Petitioners were not required to prove that IRS destroyed the records in bad faith under *Glover*. Petitioners have no "need" to prove that the destroyed records were "relevant to their assertions." The *Hongsermeier* decision itself establishes such relevance on the face of the Opinion which catalogs Tax Court Judge Beghe's use of Thompson's incomplete tax records for 1983 in his calculation of the Thompson settlement benefits.

This intra-Circuit conflict requiring proof of bad faith to support imposition of an adverse inference against the spoiliator on the one hand, and requiring only proof that the spoiliator knew or should have known that the documents destroyed had potential relevance on the other is not unusual. Since this Court's Opinion in *Rodeway Express, Inc. v. Piper*, 447 U.S. 752 (1980), the law addressing application of the adverse evidentiary inference which must be applied against the spoiliator has been in disarray.

Indeed, one would be hard pressed to find a more open conflict among the Circuits which cries out for this Court's resolution. The Second Circuit's Opinion in *U.S. v. Seltzer*, 227 F.3d 36, 41 (2d Cir. 2000) decries the current uncertainty in the law:

> In reaching this conclusion, we note that there is a split among the circuits and even within some circuits evidencing confusion about a district court's power to impose sanctions under the inherent powers doctrine. Compare *United States v. Mottweiler*, 82 F.3d 769, 772 (7th Cir. 1996) ("Negligent failure to be present when the jury returns could support a civil order requiring counsel to reimburse one's adversary, and the judicial system, for the expenses to which that delict leads."), *Republic of the Philippines v. Westinghouse Elec. Corp.*, 43 F.3d 65, 74 n. 11 (3d Cir. 1995) ("[a] court need not always find bad faith before sanctioning under its inherent powers"), *Harlan v. Lewis*, 982 F.2d 1255, 1260 (8th Cir. 1993) (rejecting argument that sanctions under inherent authority of courts always require finding of bad faith), *Kleiner*

> *v. First Nat'l Bank*, 751 F.2d 1193, 1207-08 (11th Cir. 1985) (holding that sanctions can be justified under inherent authority of court even if sanctioned party acted in good faith), and *In re Baker*, 744 F.2d 1438, 1441 (10th Cir. 1984) (en banc) (upholding sanction based on "record [that] reflects not contumaciousness, but a pattern of negligence"), with *Elliott v. Tilton*, 64 F.3d 213, 217 & n. 3 (5th Cir. 1995) (rejecting notion that finding of misconduct short of bad faith can support imposition of sanctions) (citing *Chambers*, 501 U.S. at 58 (Scalia, J., dissenting); Thomas E. Baker, *The Inherent Power to Impose Sanctions: How a Federal Judge is Like an 800-Pound Gorilla*, 14 Rev. Litig. 195, 199 & n. 15 (1994)),[fn2] *United States v. Wallace*, 964 F.2d 1214, 1219 (D.C. Cir. 1992) (reversing sanctions against attorney for costs associated with attorney's failure to subpoena witnesses in timely fashion because such failure did not constitute bad faith, and hence could not support imposition of sanctions under the inherent powers doctrine).[fn3]

Since *Seltzer*, the split has only continued to widen. See also *103 Investors I, L.P. v. Squared Co.*, 470 F.3d 985, 989 (10th Cir. 2006). *Trevino v. Ortega*, 969 S.W.2d 950, 957 (Tex. 1998) (providing a comparative list of conflicting decisions similar to *Seltzer*.)

Since *Armory v. Delamirie*, 1 S.T.R. 505, 93 Eng. Rep. 664 (K.B. 1722) was adopted as part of the federal common law of this Republic, spoiliators have been made to:

> Bear the risk of the erroneous determination resulting from their destruction of relevant evidence.

The Court of Appeals shifted the risk of the Government's destruction of evidence onto the hapless taxpayer victims. The Tax Court's decision and the Court of Appeals judgment and Opinion hold that IRS has no concomitant duty to preserve its records relevant to the Thompsons' liability because the "digital age had not yet dawned" prior to the Government's destruction. The Panel cites no authority for these propositions and none exists.

Petitioners, and all the other affected taxpayers were entitled to a determination of the benefits of the Thompson settlement which properly applied the adverse evidentiary inference which arises from spoiliation against the Commissioner.

This Court should grant certiorari to resolve this troublesome conflict among the Circuits, to bring more certainty to litigation in the Federal Courts, and to deter potential spoiliators from attempting to profit at the expense of the federal factfinding process.

CONCLUSION

Based on all the above arguments, the Petition for Writ of Certiorari should be granted. This cause should be reversed and rendered in favor of Petitioners with a holding that they are not liable for interest on any remaining portion of their tax deficiencies while the fraud perpetrated by the Commissioner's attorneys was in progress. This Petition for Writ of Certiorari should be granted and this case reversed and remanded to the Tax Court for a new determination of the amount of fraudulent benefits which the Thompson taxpayers received with proper application of the adverse inference against the Government for spoiliation of evidence.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT, FILED SEPTEMBER 1, 2010

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 07-72828

Tax Ct. No. 29643-86

RICHARD HONGSERMEIER; FIORELLA HONGSERMEIER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 07-73718

Tax Ct. No. 17993-95

RICHARD B. ROGERS; DONNA G. ROGERS,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appendix A

No. 07-73719

Tax Ct. No. 20119-84

JOHN L. HUBER; TERRY E. HUBER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 07-73818

Tax Ct. No. 17992-95

STANLEY C. TITCOMB; SHARON A. TITCOMB,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appendix A

No. 07-73822

Tax Ct. Nos. 17642-83, 38965-84, 35608-86,
479-89, 8070-90

NORMAN W. ADAIR; BARBARA L. ADAIR,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 07-73823

Tax Ct. No. 40159-84

GLORIA K. OWENS; TERRY D. OWENS,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Appendix A

No. 07-73825

Tax Ct. Nos. 4201-84, 22783-85, 30010-85

HOYT W. YOUNG; BARBARA D. YOUNG,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from a Decision of the Tax Court

Argued and Submitted November 4, 2009—
Seattle, Washington

Filed September 1, 2010

Before: Ferdinand F. Fernandez, Andrew J. Kleinfeld and Richard R. Clifton, Circuit Judges.

Opinion by Judge Clifton

OPINION

Appendix A

CLIFTON, Circuit Judge:

Petitioners are representatives of a group of taxpayers who have previously been before our court. The taxpayers participated in a tax shelter that was challenged by the government and became the subject of litigation before the Tax Court. Misconduct by government attorneys tainted that litigation. Specifically, a case was tried before the Tax Court involving "test case" taxpayers selected by the larger group of taxpayers and by the government. It was discovered after the Tax Court announced its decision from the test case that government attorneys had previously reached a settlement with one taxpayer but withheld that information from the court and from the other taxpayers so that evidence advantageous to the government could be elicited from the taxpayer during the Tax Court trial. This Court held in *Dixon v. CIR*, 316 F.3d 1041, 1047-48 (9th Cir. 2003), that the misconduct constituted fraud on the court, and we remanded the cases to the Tax Court for entry of judgment on terms equivalent to those provided to the taxpayer who was party to the secret settlement. We left it to that court to determine what the precise terms should be. The Tax Court rendered its decision, *Dixon v. CIR*, 91 T.C.M. (CCH) 1086, 2006 WL 1157520, and it was again appealed by the taxpayers. That is the appeal now before us. We affirm the Tax Court's determination of petitioners' remaining federal income tax deficiencies and liability for underpayment of interest.

Appendix A

I. Background

A. Prior Factual and Procedural History[1]

During the 1970s and 1980s, a group of individual taxpayers participated in an investment program and tax shelter designed and administered by Honolulu businessman Henry Kersting ("Kersting"). The investments, which came to bear Kersting's name, consisted of a somewhat complicated program in which participants purchased stock with loans from Kersting-controlled entities financed by two layers of promissory notes.[2] Kersting marketed the product as a legitimate investment which would enable participants to claim interest deductions on their individual tax returns. When Kersting participants claimed those deductions,[3] the IRS issued notices of deficiency, disallowing all interest deductions taken, and reasoning that the underlying

1. This portion of the background narrative is taken from our prior decision in *Dixon*, 316 F.3d at 1043-46.

2. The Kersting investment consisted of the following: (i) corporate stock or stock subscription rights or investment certificates purchased by a loan from a Kersting company (a "Primary Note"); (ii) prepayment of interest on the Primary Note financed by a secondary or "leverage" note from another Kersting entity at a lower interest rate than the Primary Note; (iii) principal on the Primary Note paid by surrender of the stock or other underlying asset; and (iv) interest on the Primary Note paid by a distribution from the corporation whose stock was purchased with the Primary Note. *Dixon v. CIR*, 62 T.C.M. (CCH) 1440, 1454-62 (1991) (original Tax Court opinion).

3. Deductions were claimed pursuant to 26 U.S.C. § 163.

transactions were shams, the interest was not "paid or properly accrued," and the notes did not constitute a bona fide indebtedness.

In a Tax Court action brought by Kersting on their behalf, program participants sought a redetermination of the deficiencies. Recognizing that the sheer number of affected taxpayers (approximately 1,800) made it impractical to try each case individually, the parties agreed to employ a "test case" approach to determine liability. To facilitate this process, the bulk of affected taxpayers signed stipulations ("piggyback agreements") agreeing to be bound by the decision of a test case trial involving representative taxpayers. The agreed-upon process provided that two representatives would be chosen by the taxpayers' attorneys and five by IRS attorneys. Approximately 1,300 taxpayers, some 500 already having settled, signed on to the piggyback agreements.

The test cases proceeded to a consolidated one-month trial before the Tax Court sitting in Honolulu. The Tax Court ultimately concluded that the taxpayers were liable for all assessed deficiencies and would be required to pay additional negligence and tax-motivated transaction penalties. Crucial to this determination was the testimony of John R. Thompson ("Thompson"), the only taxpayer who testified that he believed the instruments creating the claimed interest would not be enforced.

As it turns out, that which the Tax Court and other participants believed to be a legitimate, representative proceeding, binding on the test case petitioners and

all those waiting in the wings, was anything but. Some time prior to the test case trial, Kenneth W. McWade ("McWade"), the IRS attorney trying the case, and William A. Sims ("Sims"), the IRS attorney with supervisory authority over it, had entered into secret settlement agreements with Thompson and another test case petitioner, John R. Cravens ("Cravens"). Cravens was one of the taxpayer-selected test case representatives, chosen by taxpayer counsel because his payment of capital gains taxes upon exiting the Kersting investment program made him a particularly good representative.

A condition of their settlements required Thompson and Cravens to remain test case petitioners. McWade also convinced Cravens, who mistakenly believed his liability was finalized by the settlement, to proceed *pro se*. With respect to Thompson,[4] McWade agreed to have Thompson's tax deficiencies reduced in proportion to his attorney's fees, which exceeded $60,000. At no point did McWade or Sims reveal to the Tax Court or to any other taxpayer representative that two of the test case petitioners' cases had been settled, much less reveal the conditions imposed on them.

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4. Thompson had an ongoing dispute with Kersting over the validity of the investment certificates. Specifically, Kersting had threatened to initiate collection proceedings against Thompson. Therefore, Thompson had an interest in seeing that the certificates of investment were declared invalid and unenforceable. DeCastro, Thompson's attorney, used the test case proceeding to elicit testimony from Thompson regarding the sham nature of the notes in order to bolster Thompson's position in any subsequent litigation with Kersting.

The deception continued with a cover-up, which was carefully designed to prevent the Tax Court and other taxpayers from learning of the secret settlement agreements. At Kersting's deposition, which McWade attended, Kersting's lawyer objected to the presence of Thompson's attorney because of rumors that Thompson was attempting to settle. Knowing that Thompson had, in fact, already settled, McWade remained silent. McWade then misled the Tax Court by failing to disclose the settlement when he moved to set aside the Thompson piggy-back agreement, a pre-trial motion necessary to ensure Thompson's status as a test case petitioner. Deceptive silence matured into overt misconduct when, during the course of the test case trial, it became apparent that Thompson was going to testify about his settlement. McWade quickly shifted his questions to unrelated matters.[5]

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5. In the Tax Court proceedings on remand, Judge Beghe pointed to the following exchange as evidence of deception:

> Mr. Thompson: The procedure went through a tax firm in Los Angeles known as Loeb & Loeb, and I wound up with the DeCastro Law Corporation by way of their direction, and made several discoveries that were startling to me. And of course, I settled. To be quite honest, I had to get out of this. I was not going to spend my life—
>
> Mr. McWade: Well, let me—
>
> Mr. Thompson:—doing all this.

McWade and Sims also secured an agreement with taxpayer Dennis Alexander[6] ("Alexander") whereby the IRS would reduce Alexander's tax deficiencies in exchange for testimony and trial preparation assistance. In accordance with this agreement, the IRS paid for Alexander's expenses in Hawaii for the length of the trial. McWade then filed a memorandum regarding the basis for the settlement of Alexander's tax liabilities which the Tax Court later found to be false. During the test case trial,

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> Mr. McWade: Let me stop you here for a moment.
>
> Mr. Thompson: Okay, I'm sorry. I beg your pardon.
>
> Mr. McWade: Mr. Thompson, can you tell me: have we been successful in getting the lien removed from your house?

Thompson's use of the word "settled" did not disclose the secret settlement between Thompson and the IRS because, in the original proceeding, Judge Goffe mistakenly interpreted the remark as referring to resolution of the Thompsons' tax liability for another year which was not at issue. *Dixon v. CIR*, 77 T.C.M. (CCH) 1630, n.55. McWade did nothing to disabuse the court of its interpretation.

6. Alexander was then embroiled in a legal battle with Kersting involving more than $4 million. Alexander's animus towards Kersting was made clear in a letter to the IRS ("When the Nazi knows that 1400 of his clients are going to be clobbered and that he will have the Criminal Investigative Division of the IRS coming down on him, I think he will be inclined to pay me my money.").

McWade also sat silently through testimony by Alexander that he knew to be false.[7]

The Tax Court's test case determination left the remaining taxpayers—those who had signed on to the piggyback agreements—subject to judgment on the same adverse terms. This is when the McWade-Sims house of cards began to collapse. Thompson and Cravens, who had sat silent while the Tax Court entered judgment against them, pressured McWade and Sims to live up to the terms of their secret settlement agreements. It was now clear that the IRS would have to move to set aside the Thompson and Cravens judgments; McWade and Sims were forced to reveal the secret settlements necessitating the Tax Court's entry of "revised" judgments in favor of Thompson and Cravens.

After being asked to approve the set aside motions, senior IRS officials determined that McWade and Sims had engaged in active misconduct and informed the Tax Court of the secret settlements,[8] asking for an evidentiary hearing to determine the extent of the damage. The

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7. When one of the attorneys for the taxpayers asked Alexander if McWade had discussed a reduction of Alexander's tax deficiency in exchange for his testimony, Alexander responded, "Specifically, no." McWade failed to correct this patently false statement.

8. As the Tax Court proceeding on remand revealed, this disclosure was anything but complete, excluding, for example, the arrangement to "pay" (through a reduction in disallowed deductions) $60,000 to Thompson for his attorney fees.

Tax Court refused to hold an evidentiary hearing and proceeded to enforce the terms of the Thompson and Cravens settlements. The taxpayers appealed the refusal to this Court, which remanded with instructions to hold an evidentiary hearing. *Dufresne v. CIR*, 26 F.3d 105 (9th Cir. 1994).

On remand, the Tax Court conducted the mandated evidentiary hearing. Incredibly, McWade's pattern of deception continued with his persistent denial that the Thompson settlement was a vehicle for paying Thompson's attorneys' fees and his testimony that the Thompson settlement was attributable to a separate transaction. After making extensive findings concerning the government's misconduct, the Tax Court surprisingly concluded that what had occurred was harmless error. While the bulk of the decision from the original test case proceeding was reinstated, the Tax Court did relieve the taxpayers of that portion of the original judgment which imposed increased interest penalties for negligence and "tax motivated transactions" and imposed costs and attorneys' fees on the IRS. From the Tax Court's refusal to vacate the adverse judgments against them, the taxpayers filed an appeal to this Court, which resulted in our *Dixon* decision.

B. Our Decision in Dixon

In *Dixon* we held that the IRS counsel committed intentional fraud on the Tax Court and the taxpayers:

> There can be no question here but that the actions of McWade and Sims amounted to a fraud on both the taxpayers and the Tax Court. The Tax Court believed it was hearing a legitimate adversarial dispute when, in fact, the proceeding was a charade fraught with concealed motives, hidden payments, and false testimony. What did occur was clearly designed to defile the court itself, and there is no question that it was carried out by an officer of the court.

Dixon, 316 F.3d at 1046-47. We further concluded that the taxpayers were not required to demonstrate prejudice in order to obtain relief. The Tax Court's determination that the misconduct had been harmless to other taxpayers was set aside as an abuse of discretion.

We then set forth our conclusion as to the appropriate remedy. Because the adherence of the Tax Court on remand to our instructions is a major issue in the current appeal, we will quote in full the "Remedy" portion of our decision in *Dixon*, omitting citations and one of the two footnotes. The second footnote, note 11, is critical to our decision in the current appeal. It appears at the end of the quoted passage, and we include it at the end:

> We have the inherent power to vacate the judgment of the Tax Court, fashion an appropriate remedy and sanction a party or its lawyers for willful abuse of the judicial process, particularly when the party or its lawyers have intentionally practiced a fraud upon the court. This power, however, is to be "exercised with restraint and discretion."

Here, it plainly would be unjust to remand for a new, third trial. The IRS had an opportunity to present its case fairly and properly. Instead its lawyers intentionally defrauded the Tax Court. The Tax Court had two opportunities to equitably resolve this situation and failed. Enormous amounts of time and judicial resources have been wasted. In addition, the IRS has done little to punish the misconduct and even less to dissuade future abuse. The taxpayers should not be forced to endure another trial and the IRS should be sanctioned for this extreme misconduct.

Conversely, we will not enter judgment eradicating all tax liability of these taxpayers. Such an extreme sanction, while within the court's power, is not warranted under these facts. Instead, we remand to the trial court with directions to enter judgment in favor of Appellants and all other taxpayers properly before this Court on terms equivalent to those provided in the settlement agreement with Thompson and the IRS. n.11

> n.11. We leave to the Tax Court's discretion the fashioning of such judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided for in the Thompson settlement.

Id. at 1047.

C. The Tax Court's Decision on Remand

The task our decision in *Dixon* assigned to the Tax Court was not a purely mechanical one. All the affected taxpayers participated in the Kersting tax shelters, but

their tax returns differed in other respects and some of those differences raised separate issues. The Thompson tax returns were among those that raised other issues, and the Thompson settlement resolved more than Kersting tax shelter claims.

In order to put other taxpayers "in the same position as provided for in the Thompson settlement," *id.* at 1047 n.11, the Tax Court was required to translate the overall Thompson settlement into the different contexts presented by the tax returns of other taxpayers. It also had to decide how to treat the portion of the Thompson settlement that reduced Thompson's tax liability by the amount of his attorney's fees he paid for participating in the charade of a trial, since that did not represent an actual net savings by Thompson. With the discretionary nature of the Tax Court's decision in mind, the Commissioner argued to the Tax Court that the affected taxpayers should receive a 20 percent reduction in their tax deficiencies, while the taxpayers argued for a 100 percent or near 100 percent reduction in their deficiencies.

The Tax Court was also required to deal with the reality that both the tax laws and interest rates have changed over the years. The Tax Court noted in its order that "[t]he Thompson settlement was embodied in a sequence of payments and refunds that occurred more than 15 to 20 years ago, when personal interest was fully or partially deductible for income tax purposes, in a different interest rate environment, and in temporal relationships that are not now reproducible with respect to any of the other petitioner participants in the Kersting project." *Dixon*, 91 T.C.M. (CCH) 1086, 2006 WL 1157520, at *26.

The Tax Court's effort was further complicated by the fact that there was no comprehensive written agreement documenting the terms of the Thompson settlement. There was a written agreement at one point, but it was subsequently modified, culminating in an oral agreement between the IRS attorneys and the attorney for Thompson. That meant, among other things, that it was not clear which resolutions were reached concerning various non-Kersting issues over several tax years, including years not otherwise connected with the Kersting tax shelter, related to the Kersting shelter settlement and which, if any, were independent of the settlement.

The Tax Court ultimately determined that the "Kersting-related deficiencies" for each affected taxpayer should be reduced by 63.37 percent, thereby requiring taxpayers to pay 36.63 percent of the income tax they allegedly otherwise would have owed. *Id.* at 47. The Tax Court calculated this percentage by constructing a fraction with a numerator representing the tax actually paid by Thompson and a denominator reflecting Thompson's alleged tax liability absent the settlement. Specifically, the Tax Court used a numerator of $30,000, representing the portion of the total deficiencies that was actually paid by Thompson over the 1979-1981 period.[9] The denominator was calculated by starting with $79,294, the sum of the deficiencies initially asserted against Thompson by the Commissioner for the tax years in question, 1979-1981. To that amount was added two additional benefits received by

9. The Tax Court declined to include within the numerator the amounts paid by Thompson for attorney's fees.

Thompson: (a) an adjustment of $980 representing a deficiency in Thompson's 1983 tax that the IRS did not assess and Thompson did not pay, and (b) an adjustment of $1,624 representing a tax savings by Thompson attributable to the Commissioner's allowance of a 1987 personal interest deduction that was overstated by $5,814. Summing those figures produced a total denominator of $81,898. Dividing $30,000 by $81,898 produced a fraction equivalent to 36.63 percent, representing the proportion of tax the Tax Court found had been paid by Thompson. *Id.* That meant that the settlement reduced what he was required to pay in taxes in connection with the Kersting shelter by 63.37 percent.

The Tax Court also addressed a separate tax program, the Bauspar program, through which Thompson and certain other Kersting project participants "apparently deducted substantial amounts as home mortgage interest on their 1983-85 returns, on the basis of payments under the Bauspar program that may not have met the requirements for deductible home mortgage interest." *Id.* at 40. Finding that the benefit Thompson derived from overstated Bauspar interest deductions was not readily ascertainable because the payees of claimed mortgage interest are not identified in the returns and that the Commissioner disallowed Bauspar deductions only sporadically for a small number of taxpayers, the Tax Court determined that it was not appropriate to deal with the Bauspar program as part of its calculation of the percentage deduction that would apply to all taxpayers. *Id.* Rather the court directed that "any disallowed deductions relating to Bauspar are to be treated as valid deductions with respect to those taxpayers who may have claimed

them" because "[t]hat's the way Bauspar played out for the Thompsons . . . ." *Id.* at 47.

The Tax Court also accorded other benefits to the taxpayers under the *Dixon* mandate. Noting that many Kersting participants had remaining penalties and additions and "[i]t seems especially incongruous to impose an addition for a few months' delay in filing a return at this time, when 25 years have passed since that delay occurred," the Tax Court concluded that "[a]ll affected taxpayers are to be relieved of all penalties and additions to tax that were determined in their statutory notices of deficiency, not just Kersting-related items such as negligence additions." *Id.* The Tax Court also found that approximately 100 Kersting taxpayers had non-Kersting-related deficiencies, and, again noting the long delay in resolving this matter, the court directed that "all non-Kersting-related deficiencies determined in the notices of deficiency for all affected taxpayers with taxable years still before this Court be eliminated." *Id.*

The Tax Court also noted areas of agreement where all parties "establish[ed] some common ground regarding the relief to which those beneficiaries are entitled." *Id.* at 32. The court accepted the parties' stipulation that the Thompson settlement involved a "burnout" element that

effected a reduction in the underpayment of interest that would otherwise arise under I.R.C. § 6601.[10] *Id.*

The government did not appeal the Tax Court's judgment. Taxpayers filed this timely appeal. We have jurisdiction pursuant to 26 U.S.C. § 7482.

Petitioners Richard and Fiorella Hongsermeier, Terry and Gloria Owens, and Hoyt and Barbara Young served as test case petitioners in the original litigation before the Tax Court, while petitioners Norman and Barbara Adair, Richard and Donna Rogers, John and Terry Huber, and Stanley and Sharon Titcomb initially entered into "piggy-back" agreements to be bound by the Tax Court's determination in the test cases. The Adairs, Owens, and Youngs consolidated their cases on appeal to this Court, as

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10. The Tax Court opinion explained the "burnout" element as follows:

> (a) for taxpayers with 2-3 taxable years before the court, the first year's deficiencies are shifted forward and combined with the deficiencies in the second year then reduced in accord with the Ninth Circuit's mandate; and
>
> (b) for taxpayers with 4 or more taxable years before the court, the first year's deficiencies are shifted forward to the second year and the second year's deficiencies are shifted forward and combined with the deficiencies in the third year, after which all deficiencies are reduced in accord with the Ninth Circuit's mandate.

Dixon, 91 T.C.M. (CCH) 1086, 2006 WL 1157520, at *32.

did the Rogers, Hubers, and Titcombs. We consolidated all cases for the purposes of oral argument, and now resolve the appeals in all of the cases in this opinion.

II. Discussion

We review the Tax Court's conclusions of law de novo, its factual findings for clear error, and its discretionary rulings for abuse of discretion. *Kelley v. CIR*, 45 F.3d 348, 350 (9th Cir. 1995). The Tax Court's evidentiary rulings are reviewed for abuse of discretion and will not be reversed absent a showing of prejudice. *Sparkman v. CIR*, 509 F.3d 1149, 1156 (9th Cir. 2007).

A. The Tax Court's Remedy

We conclude that the Tax Court's findings are well supported in its comprehensive review of the record and do not leave "the definite and firm conviction that a mistake has been committed." *Sparkman*, 509 F.3d at 1155 (quotation marks omitted). The Tax Court's determination of the percentage deduction in the taxpayers' deficiencies, plus other benefits, accords with this Court's mandate in *Dixon* and is not an abuse of discretion. *See Jim Turin & Sons v. CIR*, 219 F.3d 1103, 1105 (9th Cir. 2000) ("[W]e independently review for abuse of discretion, and our task is to determine whether [the exercise of discretion] is clearly unlawful or plainly arbitrary." (footnote omitted)).

Taxpayers argue that the Tax Court's remedy fails to comply with the *Dixon* mandate and challenge, in various

ways, the Tax Court's calculation of the 63.37 percent figure.

B. Elimination of Taxpayers' Deficiencies

The Hongsermeiers first argue that the taxpayers' refunds should be accepted as filed to allow a 100 percent reduction in their tax deficiencies based on this Court's finding in *Dixon* of fraud on the court, continued fraud on the court on the part of the Commissioner following *Dixon*, and a lack of complete information concerning the Thompson settlement.

This Court has the power to vacate or amend a judgment of the Tax Court and to fashion an appropriate remedy upon a finding of fraud on the court. *See In re Levander*, 180 F.3d 1114, 1119 (9th Cir. 1999). *In Dixon*, we did indeed find that "the taxpayers . . . clearly and convincingly demonstrated fraud on the court and are entitled to relief." 316 F.3d at 1047. We specifically chose, however, to "not enter judgment eradicating all tax liability of these taxpayers." *Id.* The option of a 100 percent reduction in taxpayers' deficiencies was already rejected by this Court, which noted that "[s]uch an extreme sanction, while within the court's power, is not warranted under these facts." *Id.* We instead remanded the case to the trial court, leaving to the Tax Court's discretion the fashioning of a settlement for the affected taxpayers equivalent to that offered to Thompson. The Tax Court followed our mandate by not eliminating all tax liability for the taxpayers, and properly so. A trial court is prohibited from giving relief beyond the scope of

an appellate mandate. *See Caldwell v. Puget Sound Elec. Apprenticeship & Training Trust*, 824 F.2d 765, 767 (9th Cir. 1987).

The Hongsermeiers' argument that further fraud on the court following *Dixon*, or, in the alternative, unconscionable bad faith, should prompt this Court to vacate the Tax Court's judgment and eliminate 100 percent of taxpayers' deficiencies is also flawed. The Hongsermeiers contend that the Commissioner's representation on remand that Thompson received only a 20 percent reduction in his tax deficiencies was not only false, but also contradicted two previous statements: the first, by Sims in a 2003 state bar disciplinary proceeding stating that the Thompson settlement was a 50 percent reduction in tax deficiencies, and the second, by the former Chief of the Appellate Section of the Department of Justice's Tax Division, reporting in 1992 that Thompson received a 65 percent reduction in deficiencies.

While, as previously noted, we may vacate the Tax Court's judgment upon a finding of fraud on the court, there is no evidence in the record that, following *Dixon*, the Commissioner acted in a manner at all amounting to "an unconscionable plan or scheme which is designed to improperly influence the court in its decision." *England v. Doyle*, 281 F.2d 304, 309 (9th Cir. 1960) (defining fraud on the court). The Commissioner simply argued on remand that the Thompson settlement amounted to a 20 percent reduction in what Thompson had to pay because the Commissioner explicitly disregarded reductions Thompson used to pay his attorney's fees as not

representing a net savings to Thompson. Attorney's fees of other taxpayers were paid for by Kersting, the promoter of the tax shelter. While the Tax Court rejected that argument, the Commissioner's position did not constitute fraud on the court or bad faith, nor was it related to the fraud initially perpetrated by Sims and McWade.

C. Calculation of the Tax Court's Remedy

Taxpayers also argue that the Tax Court's calculation of the 63.37 percent figure did not take into account the full benefits offered to Thompson. Specifically, the Hongsermeiers argue that the Court should order a 90.1 percent reduction of their deficiencies, and the Adairs, Owens, and Youngs argue that the Court should order a 98 percent reduction of their deficiencies.

The Hongsermeiers base their calculation of the terms of the Thompson settlement on a letter from Sims to Thompson's attorney, dated May 29, 1992, estimating that the taxes Thompson owed, plus statutory additions and interest, would be "approximately $302,396.12." The Hongsermeiers used the numerator of $30,000, representing the total deficiencies paid by Thompson over the 1979-1981 period, and divided that number by a denominator of $302,396.12 to produce the 90.1 percent figure.

It is undisputed that the total tax deficiencies asserted against Thompson for the years 1979-1981 was $79,294, and that Thompson's final settlement reduced those deficiencies to $30,000. The alternative denominator

offered by the Hongsermeiers in this appeal is based on their vague contention that various additions, interest, and penalties should be included in the denominator of the Thompson settlement fraction. As discussed above, the Tax Court did add two figures to the denominator based on additional benefits received by Thompson: (a) $980 to represent the unpaid deficiency in Thompson's 1983 tax, and (b) $1,624 to represent Thompson's tax savings due to the Commissioner's allowance of an overstated personal interest deduction for 1987. The Tax Court therefore determined that the appropriate denominator was $81,898.

The $302,396.12 figure asserted by the Hongsermeiers does not represent the reduction in Thompson's actual liability in comparison to the amount they were able to pay in settlement because it does not take into account advance payments that Thompson made in 1986 and 1987 of $121,770 in both tax and interest owed. Thompson did not "save" amounts he actually paid. The Tax Court did not relieve the taxpayers of interest liability because, as discussed below, Thompson paid his interest in full. *See infra* Part II, E.

The Hongsermeiers also separately assert that the Tax Court should have increased the denominator of the Thompson settlement fraction by $4,934.32 to include the late filing addition in Thompson's statutory notice of deficiency for 1981, which Thompson would have been required to pay had he not settled his tax liabilities. Rather than give a credit or add this figure to the denominator of the Thompson settlement fraction, the Tax Court instead chose to eliminate all penalties related to non-Kersting

additions for all affected taxpayers. Noting that taxpayers' "proposed application of non-Kersting penalties and additions was specific to individual taxpayers, unlike the Kersting-related deficiencies and additions for which all affected taxpayers are liable," the Tax Court found that it was appropriate to limit the benefit of relief from non-Kersting additions to those affected taxpayers who, like Thompson, were subject to non-Kersting additions. *Dixon*, 91 T.C.M. (CCH) 1086, 2006 WL 1157520, at *36.

Certain taxpayers, including the Hongsermeiers, did not have any additional non-Kersting-related penalties asserted against them. The Tax Court's decision to eliminate all non-Kersting penalties was well within the Tax Court's mandated discretion, however, for the Tax Court was not required to fashion individual remedies for taxpayers based on their lack of non-Kersting-related additions. The Tax Court noted in its decision that "memories have faded and records have been lost or destroyed during the long delay in resolution of the Kersting issues," making it difficult to assess the status of each taxpayers' non-Kersting related issues and thus "inherently unfair" to "impose upon those petitioners the burden of proving those deficiencies to be erroneous." *Id.* at 47. Furthermore, the court stated that "the non-Kersting issues are relatively minor when compared to the Kersting-related deductions that are at issue in all these cases." *Id.* The court therefore concluded that the appropriate remedy was to eliminate all non-Kersting related penalties, additions, and deficiencies for all affected taxpayers. That determination was not an abuse of discretion.

Appendix A

The Adairs, Owens, and Youngs argue that the Tax Court did not take into account tax benefits Thompson received in tax years 1982 and 1983 in its determination of the denominator in the Thompson settlement fraction, which, by their calculations, allowed Thompson to pay less than two percent of his taxes. This argument is premised on the incorrect assumption that the Commissioner's treatment of Thompson's 1982 tax return was part of the Thompson settlement agreement, as well as on an incorrect calculation of Thompson's savings for tax year 1983.

The argument is based on an August 3, 1989 letter sent from Thompson's attorney, DeCastro, to McWade, which states: "We have agreed that the total taxes due for all the open years are $15,000 for 1980 and $15,000 for 1981." The Tax Court determined, however, that the statutory period of limitations for 1982 had expired in 1986, and therefore Thompson's 1982 taxable year was not an "open year" to which the letter could have applied. Thompson filed his 1982 tax return on May 6, 1983, and on this tax return he claimed Kersting-related tax deductions which reduced his adjusted gross income of $99,362 to $4,336 for tax purposes. No action was taken concerning this tax return, and the statute of limitations under I.R.C. § 6501 expired in May 1986. The settlement which this court held to be a fraud on the court was negotiated on behalf of Thompson by DeCastro, and Thompson did not retain DeCastro as his attorney until November 1986. Therefore, the Tax Court reasonably determined that the Commissioner's failure to act on the 1982 tax return could not have been part of the Thompson settlement agreement between DeCastro and McWade.

The Adairs, Owens, and Youngs also assert that Thompson's 1982 tax year should be considered an "open year" because fraud on the part of Thompson rendered the statute of limitations inapplicable pursuant to I.R.C. § 6501(c)(1). "Fraud implies bad faith, intentional wrongdoing and a sinister motive." *Powell v. Granquist*, 252 F.2d 56, 60 (9th Cir. 1958) (quotation marks omitted). The Tax Court did not find, based on its evaluation of the credibility of Thompson during the evidentiary hearing mandated by *DuFresne*, that Thompson specifically intended to evade a tax known to be owing. There is no evidence that the Tax Court clearly erred in finding that Thompson's 1982 tax year was not an open year to which DeCastro's 1989 letter could have applied. Consequently, the Tax Court's determination that any benefits Thompson received from that year should not be included in the Thompson settlement fraction was not an abuse of the Tax Court's discretion.

The Adairs, Owens, and Youngs also argue that the Tax Court erred in failing to include in its Thompson settlement calculation savings in the amount of $19,717.99 as a benefit for tax year 1983. The Tax Court agreed with the taxpayers that the treatment of tax year 1983 should be included within the benefits obtained by Thompson as part of the settlement.[11] It found, however, that Thompson

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11. As with tax year 1982, the Commissioner allowed the statute of limitations to expire without collecting the identified deficiency for tax year 1983. Unlike tax year 1982, however, the Tax Court determined that the benefit obtained by Thompson should be taken into account as part of the settlement and included as part of the denominator of its calculation because McWade and

received a benefit from the settlement of only $980 for tax year 1983. The argument that Thompson received tax savings of $19,717.99 instead of $980 for tax year 1983 erroneously assumes that Thompson had sufficient income for that year to make complete use of his Kersting deductions. He did not. The tax deficiency which he avoided based on the disallowance of $67,620 of Kersting deductions totaled only $980. That is all he actually saved. It was not an abuse of discretion for the Tax Court to use that amount in calculating the benefit obtained by Thompson from the settlement.

The Adairs, Owens, and Youngs argue that the IRS failed to preserve critical documents, including Thompson's 1982 tax return and the administrative files for tax years 1982 and 1983, which would prove that the "IRS granted Thompson audit forbearance for other open tax years not before the Tax Court, allowed all of Thompson's Kersting deductions, and settled the validity of the Kersting deductions, in favor of Thompson, for all open tax years as part of the Thompson settlement." Particularly at a time when tax filings were made on paper rather than electronically, the IRS could not and did not keep all records for all years. There is no evidence that the IRS destroyed documents to cover up its attorneys' misconduct or to hinder the calculation of the benefits obtained by Thompson. Nor have we been given any reason to believe that the destroyed records would prove any of the taxpayers' assertions. The Tax Court did not

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the attorney for Thompson were actively involved in discussions at the time the Thompson statutory notice of deficiency for 1983 was being prepared.

abuse its discretion in relying on the materials available to determine the Thompson settlement fraction.

D. Discovery Requests

The taxpayers also requested that the Tax Court order the production of additional documents by the Commissioner, arguing that these documents were necessary to determine whether there was continuing fraudulent conduct on the part of the Commissioner. The Hongsermeiers filed with the Tax Court a motion for reconsideration of the Tax Court's opinion on remand, asserting that the Commissioner engaged in a continuing cover-up of the fraud and requesting that the Tax Court reopen the record and impose additional sanctions on the Commissioner. In a supplemental opinion responding to the motion for reconsideration, the Tax Court held that the law of the case and our mandate in *Dixon* "preclude[d] [the Tax Court] in the cases at hand from conducting any further inquiry into respondent's misconduct and from imposing any additional sanction . . . ." *Dixon v. CIR*, 92 T.C.M. (CCH) 245, 2006 WL 2577847, at *1. Under the law of the case doctrine, "one panel of an appellate court will not as a general rule reconsider questions which another panel has decided on a prior appeal in the same case." *Kimball v. Callahan*, 590 F.2d 768, 771 (9th Cir. 1979). In *Dixon*, despite taxpayers' claims of continuing fraud on the part of the Commissioner and our awareness of the "persistence and concealment" of the original misconduct, we did not order another evidentiary hearing, as we had in *DuFresne*, but rather ordered the Tax Court to fashion a remedy for the taxpayers equivalent to the Thompson

settlement. *Dixon*, 316 F.3d at 1043, 1047. Recognizing that "[e]normous amounts of time and judicial resources have been wasted" and "taxpayers should not be forced to endure another trial," we held in *Dixon* that the proper solution was a financial remedy and not a further inquiry into the alleged misconduct. *Id.* at 1047.

Moreover, following *Dixon*, the Tax Court granted almost all of the taxpayers' discovery requests, amounting to over 200 documents and items described in the IRS's privilege log, "for the limited purpose of ascertaining respondent's understanding of the origins and nature of the Thompson settlement." *Dixon*, 92 T.C.M. (CCH) 245, 2006 WL 2577847, at *5. There was only one exception. Documents listed under Item 123 of the IRS privilege log were reviewed by the Tax Court *in camera*, and the court found they were not directly relevant to its determination of the scope of the Thompson settlement. The Tax Court thus sustained the Commissioner's invocation of the deliberative process privilege for these documents filed under Item 123, which include printed e-mail and facsimile transmissions, memorandums, proposed pleadings and other correspondence created and maintained by the Commissioner's counsel, Henry E. O'Neill, beginning in mid-1992 following the discovery and disclosure of the Thompson settlement and during the course of litigation.

Petitioners Rogers, Huber, and Titcomb appeal this denial of disclosure, arguing that the documents filed under Item 123 may contain further information regarding misconduct on the part of the Commissioner. This discovery request exceeds the mandate in *Dixon*, however,

for the Court in *Dixon* ordered a financial settlement for the taxpayers equivalent to that offered to Thompson and not further exploration into IRS misconduct or additional sanctions. Based on the Tax Court's mandated role to create a financial settlement for the taxpayers, the denial of the discovery request for materials listed under Item 123 was not an abuse of discretion.

Furthermore, the deliberative process privilege permits the government to withhold documents that "reflect[ ] advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and polices are formulated." *NLRB v. Sears, Roebuck & Co.*, 421 U.S. 132, 150 (1975) (quotation marks omitted). Documents must be both "predecisional" and "deliberative" to qualify for this privilege; a document is predecisional if it was "'prepared in order to assist an agency decisionmaker in arriving at his decision,'" and deliberative if its release would "'expose an agency's decisionmaking process in such a way as to discourage candid discussion within the agency and thereby undermine the agency's ability to perform its functions.'" *Carter v. U.S. Dep't of Commerce*, 307 F.3d 1084, 1089 (9th Cir. 2002) (quoting *Assembly of Cal. v. U.S. Dep't of Commerce*, 968 F.2d 916, 920 (9th Cir. 1992). The documents listed under Item 123 are both predecisional and deliberative, for the privilege log describes them as materials created during decision-making processes by the Office of Chief Counsel of the IRS over the course of the Kersting project litigation. The Tax Court therefore did not abuse its discretion in determining that the documents were protected by the deliberative process

privilege based on the need to protect uninhibited dialogue and deliberations by government agencies. *See Lahr v. Nat'l Transp. Safety Bd.*, 569 F.3d 964, 979 (9th Cir. 2009) (The deliberative process privilege "shields certain intra-agency communications from disclosure to allow agencies freely to explore possibilities, engage in internal debates, or play devil's advocate without fear of public scrutiny." (internal citation and quotation marks omitted)).

E. The Tax Court's Imposition of Liability for Interest on the Remaining Deficiencies

Under I.R.C. § 6601, interest runs from the date a tax is due to be paid until the date the tax is paid. The Tax Court's determination that taxpayers' tax deficiencies should be reduced by a factor of 63.37 percent thus eliminated their liability for interest with respect to the portion of the tax liability that was eliminated. The Tax Court found, however, that taxpayers remained liable for underpayment of interest on the tax deficiencies for which they were liable after the application of the Thompson settlement terms.

The Commissioner voluntarily agreed to suspend the running of interest on all Kersting taxpayers' deficiencies beginning in June 1992 and remaining suspended until 90 days after the Tax Court entered its judgment on remand.[12]

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12. The Commissioner's agreement to suspend interest as of June 1992 does not affect the Tax Court's determination of taxpayers' interest due prior to June 1992. This concession was a voluntary, self-imposed sanction, which the Tax Court noted was "an appropriately targeted response to the consequences of

Taxpayers argue, however, that interest should have stopped accruing on their tax deficiencies on December 31, 1986, the date Thompson stopped accruing interest on his tax deficiencies, in order to adhere to the *Dixon* mandate. The question on appeal is thus whether taxpayers remain liable for interest accrued from December 31, 1986 to June 1992, as well as for interest that has accrued to the present starting on September 13, 2007, the date that was 90 days after the Tax Court's decisions were entered in most of the consolidated group of cases that were before the Tax Court on remand, including all petitioners here.

Pursuant to I.R.C. § 6601(a), "[i]f any amount of tax imposed by this title . . . is not paid on or before the last date prescribed for payment, interest on such amount at the underpayment rate established under section 6621 shall be paid for the period from such last date to the date paid." Although in some circumstances a court may have discretion in determining whether prejudgment interest should be owed, in this context the statute indicates that interest "shall" be paid. *See Grauvogel v. CIR*, 768 F.2d 1087, 1090 (9th Cir. 1985) ("The statute itself provides the means for a taxpayer to stop the interest provision from operating.").

The Tax Court found that Thompson paid full interest on his tax deficiencies, as imposed by I.R.C. § 6601(a). While Thompson did stop accruing interest in 1986, this occurred because Thompson paid his interest liability

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[the Commissioner's] former attorneys' fraud on the court, which caused substantial delay in the resolution of the Kersting project cases."

in 1986, not because he received an adjustment to his interest due. It is true that Thompson did not pay the actual deficiencies themselves until six months after he paid his interest liability, but the Tax Court ruled under *Perkins v. CIR*, 92 T.C. 749, 760 (1989), that Thompson's payment of accrued interest was deductible in the year paid even though the underlying tax had not been paid. *See* I.R.C. § 163(a) (permitting deduction of interest without requiring that the underlying obligation be paid); I.R.C. § 461(f) (permitting deduction of interest in the year in which it is paid, even though taxpayer's liability for the underlying debt is contested).

Taxpayers also point to a special feature of the Thompson settlement which allowed a replacement check Thompson paid in February 1987 to be credited as a payment on December 31, 1986. The Tax Court noted this in its opinion on remand, building into the reduced tax deficiency figure for taxpayers the tax benefit received by Thompson as a result of crediting the payment in 1986. The court did not address whether Thompson should have accrued an additional six weeks' worth of interest. Nonetheless, Thompson ultimately received refunds for overpayments made in 1986 and 1987, so it would be illogical to conclude that he had amounts still owing after December 31, 1986.

It is true that taxpayers were not offered the benefit of the Thompson settlement terms in 1986. Taxpayers therefore did not have the option to pay their tax deficiencies in 1986 based on the terms offered to Thompson and thus stop interest from accruing on their

deficiencies. Nonetheless, this Court's mandate in *Dixon* calling for a settlement that puts taxpayers in the "same position" as Thompson does not require taxpayers' interest be extinguished past 1986, because the Thompson settlement did not involve a cancellation or reduction in the interest owed by Thompson on his tax deficiencies. Indeed, some taxpayers involved in the Kersting tax shelter and related litigation did make prepayments on their deficiencies to stop interest accruing on their accounts just as Thompson did.

The taxpayers who did not make prepayments continued to receive the economic benefits of their funds, while Thompson lost the use of his funds by paying all tax deficiencies and interest in 1986 and 1987. As the Tax Court noted, taxpayers therefore were granted "the equivalent of an interest-free loan of the reduced deficiencies and interest they will now have to pay." *Dixon*, 91 T.C.M. (CCH) 1086, 2006 WL 1157520, at *28. "Section 6601(a) is not a penalty for late payment but merely compensation for delayed payment in the nature of interest on a loan." *Grauvogel*, 768 F.2d at 1090; *see also United States v. Childs*, 266 U.S. 304, 309-10 (1924) (interest on income tax is "clearly intended to compensate the delay in payment of the tax—the detriment of its nonpayment, to be continued during the time of its nonpayment—compensation, not punishment."). Cancelling taxpayers' interest payments beyond 1986 would accord taxpayers a benefit well beyond that received by Thompson.

III. Conclusion

The Tax Court did not abuse its discretion in fashioning a remedy for petitioners. The adjustments set out in the Tax Court decision fairly and reasonably complied with our direction to "put these taxpayers in the same position as provided for in the Thompson settlement," "to the extent possible and practicable." *Dixon*, 316 F.3d at 1047 n.11.

AFFIRMED.

APPENDIX B — UNITED STATES TAX COURT, T.C. MEMO 2006-90

UNITED STATES TAX COURT
T.C. Memo. 2006-90

JERRY AND PATRICIA A. DIXON, ET AL.,[1]
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

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1. Cases of the following petitioners have been treated as cases related to the above-captioned case for purposes of the additional evidentiary hearing required to give effect to the mandates of the Court of Appeals for the Ninth Circuit in *Dixon v. Commissioner*, 316 F.3d 1041, 1047 (9th Cir. 2003), as amended Mar. 18, 2003 (Dixon V), revg. and remanding T.C. Memo. 1999-101 (Dixon III): Robert H. and Barbara A. Gridley, docket Nos. 10588-83, 10931-84, 38757-84; Norman W. and Barbara L. Adair, docket Nos. 17642-83, 38965-84, 35608-86, 479-89, 8070-90; Ronald L. and Mattie L. Alverson, docket No. 17646-83; Russell L. Fleer, Sr. and Sally A. Fleer, docket Nos. 27053-83 and 13477-87; Hoyt W. and Barbara D. Young, docket Nos. 4201-84, 22783-85, 30010-85; Robert L. and Carolyn S. DuFresne, docket Nos. 15907-84, 30979-85; John L. and Terry E. Huber, docket No. 20119-84; Arden L. and Barbara G. Blaylock, docket No. 28723-84; Terry D. and Gloria K. Owens, docket No. 40159-84; Richard and Fiorella Hongsermeier, docket No. 29643-86; Willis F. McComas, II and Marie D. McComas, docket No. 19464-92; Wesley Armand and Sherry Lynn Cacia Baughman, docket No. 621-94; Joe A. and JoAnne Rinaldi, docket No. 7205-94; Norman A. and Irene Cerasoli, docket No. 9532-94; Stanley C. and Sharon A. Titcomb, docket No. 17992-95; Richard B. and Donna G. Rogers, docket No. 17993-95. The 27 related cases have been consolidated for briefing and opinion.

Appendix B

Filed May 2, 2006.

Docket Nos. 9382-83, 10588-83, 17642-83, 17646-83, 27053-83, 4201-84, 10931-84, 15907-84, 20119-84, 28723-84, 38757-84, 38965-84, 40159-84, 22783-85, 30010-85, 30979-85, 29643-86, 35608-86, 13477-87, 479-89, 8070-90, 19464-92, 621-94, 7205-94, 9532-94, 17992-95, 17993-95.

In *Dixon v. Commissioner*, 316 F.3d 1041 (9th Cir. 2003), revg. and remanding T.C. Memo. 1999-101, the Court of Appeals held that the misconduct of R's trial attorney and his supervisor in the trial of the test cases for the Kersting tax shelter project, in agreeing with counsel for T, one of the test case Ps, to a secret settlement of T's deficiencies (not disclosed to IRS management, to this Court, or to counsel for other test case Ps), was a fraud on the Court. The Court of Appeals ordered this Court to sanction R by entering judgment in favor of the remaining test case Ps and other Ps in the Kersting tax shelter group before the Court on "terms equivalent to those provided in the [final] settlement agreement with [T] and the IRS", leaving to this Court's discretion "the fashioning of such judgments, which to the extent possible

and practicable, should put these taxpayers in the same position as provided in the [T] settlement".

R argues that the substance of the T settlement was a 20-percent reduction of T's 1979-1981 deficiencies, plus the payment of T's attorney's fees. Ps argue that the T settlement was, in form and substance, a 62.17-percent reduction of T's 1979-1981 deficiencies, plus other benefits that bring the T settlement to a 79.92-percent reduction in the deficiencies. The parties agree that the T settlement also included cancellation of all additions and penalties, including nonshelter-related additions and penalties, and the use of a "burnout" to reduce the accrual of interest on the remaining deficiencies. Ps argue that interest on the deficiencies should not be charged beyond Dec. 31, 1986, which, in their view, marks the inception of the fraud on the court. R has conceded that no interest will be charged on the deficiencies for the period of the appeals to the Ninth Circuit commencing in 1992.

Held: The final settlement of T's 1979-1981 deficiencies amounts to a 62.17-percent reduction of those deficiencies.

Held, further: Two minor additional benefits included in the T settlement bring the reduction percentage up to 63.37 percent.

Held, further: The T settlement encompasses and requires the vacating of the portion or portions of the deficiencies determined against any Ps that may be attributable to the

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"Bauspar" shelter that was also promoted by Kersting and to any other issues not arising from shelters promoted by Kersting.

Held, further: Interest on the reduced deficiencies shall not be charged beyond the date in 1992 fixed by R's concession and shall not be stopped as of any earlier date.

Henry G. Binder and *John A. Irvine*, for petitioners in docket Nos. 9382-83, 15907-84, and 30979-85.

Joe Alfred Izen, Jr., for petitioners in docket Nos. 17642-83, 4201-84, 38965-84, 40159-84, 22783-85, 30010-85, 35608-86, 479-89, and 8070-90.

Robert Alan Jones, for petitioners in docket Nos. 17646-83, 10931-84, 38757-84, 19464-92, 621-94, and 9532-94.

Declan J. O'Donnell, for petitioners in docket Nos. 10588-83, 27053-83, 28723-84, and 13477-87.

Michael Louis Minns and *Enid M. Williams*, for petitioners in docket No. 29643-86.

Robert Patrick Sticht and *Boris Orlov*, for petitioners in docket No. 7205-94.

Robert Patrick Sticht, for petitioners in docket Nos. 20119-84, 17992-95, and 17993-95.

Henry E. O'Neill and *Peter R. Hochman*, for respondent.

Appendix B

[TABLE OF CONTENTS INTENTIONALLY OMITTED]

Appendix B

MEMORANDUM FINDINGS OF FACT AND OPINION[2]

BEGHE, *Judge*: With this opinion, the Court hopes to provide a template for resolution of the more than 1,300[3] remaining cases of petitioner participants in the

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2. This opinion is issued pursuant to the mandates of the Court of Appeals for the Ninth Circuit in Dixon V, revg. and remanding Dixon III. Dixon III had supplemented our Memorandum Findings of Fact and Opinion in *Dixon v. Commissioner*, T.C. Memo. 1991-614 (Dixon II), vacated and remanded per curiam sub nom. *DuFresne v. Commissioner*, 26 F.3d 105 (9th Cir. 1994). For the record, Dixon I is reported as *Dixon v. Commissioner*, 90 T.C. 237 (1988), holding that petitioners had failed to establish standing to contest a search of Kersting's office, thereby sustaining the validity of the deficiency notices generated by the information discovered in that search. Dixon IV, reported as *Dixon v. Commissioner*, T.C. Memo. 2000-116, provided for awards of attorney's fees under sec. 6673(a)(2) to petitioners in Dixon III.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

3. In addition to the more than 1,300 open cases, petitioners in 52 of the more than 500 other dockets in the Kersting project in which stipulated decisions were entered, both before and after discovery and disclosure of the misconduct held by the Court of Appeals in Dixon V to have constituted fraud on the Court, have filed motions for leave to file motions to vacate their decisions. The Court has returned unfiled numerous other such motions because of procedural defects. Petitioners filing or attempting to file such motions have thereby sought to become entitled to the benefits of the Thompson settlement as mandated by the Court of Appeals in Dixon V. Motions for reconsideration have been filed in the

second generation[4] of tax shelter programs (the Kersting project) promoted by Henry F.K. Kersting (Kersting).[5] During the trial on the merits of the test cases used to try to resolve the vast majority of the pending cases in the Kersting project,[6] respondent's trial counsel Kenneth W.

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three dockets addressed in *Lewis v. Commissioner*, T.C. Memo. 2005-205, in which we denied petitioners' motions for leave to file motions to vacate stipulated decisions in Kersting-related cases.

4. In *Pike v. Commissioner*, 78 T.C. 822 (1982), affd. without published opinion 732 F.2d 164 (9th Cir. 1984), this Court sustained respondent's disallowance of all deductions for interest, losses, and credits claimed by participants in Kersting's first-generation programs.

5. For additional information about the Kersting project, see *infra* Parts I.A. and I.B. Before his death on Mar. 4, 2000, Kersting and the tax shelter programs he promoted were frequently before the courts. In addition to those cases cited *supra* notes 2, 3, and 4, see also, e.g., *United States v. Kersting*, 891 F.2d 1407 (9th Cir. 1989) (holding that an IRS summons was enforceable against some Kersting program participants); *Richards v. Commissioner*, T.C. Memo. 1997-149, Supplemental Opinion T.C. Memo. 1997-299 (upholding Kersting project deficiency notice), affd. without published opinion 165 F.3d 917 (9th Cir. 1998); *Gridley v. Commissioner*, T.C. Memo. 1997-210 (denying petitioners' motions for summary judgment to obtain benefit of Thompson settlement); *Kersting v. United States*, 206 F.3d 817 (9th Cir. 2000) (promoter penalties upheld); *Kersting v. Commissioner*, T.C. Memo. 1999-197 (sustaining deficiencies against Kersting personally); *United States v. Kersting*, 77 AFTR 96-1717 (Bankr. D. Haw. 1996) (denying Kersting bankruptcy discharge).

6. In 1986, counsel for the parties in the Kersting-related cases agreed to a test case procedure, under which a few typical cases are selected as test cases, while the petitioners whose

McWade (McWade) (with the knowledge and connivance of his supervisor, Honolulu District Counsel William A. Sims (Sims)), entered into secret settlements with Luis DeCastro (DeCastro), counsel for test case petitioners John R. and Maydee Thompson (the Thompsons). The financial terms of the final settlement were much more advantageous to the Thompsons than the settlements generally made available to other petitioner participants in the Kersting project.[7] The final settlement with the Thompsons was intended to provide refunds of tax and interest paid by the Thompsons under a prior settlement, plus interest thereon, that were to be used--and the bulk of the refunds was used--to pay DeCastro's fees for providing the appearance of his independent representation of the Thompsons at the trial of the test cases. After this Court upheld respondent's determinations and entered decisions in favor of respondent in all the test cases, see *Dixon v. Commissioner*, T.C. Memo. 1991-614 (Dixon

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cases are not selected as test cases are encouraged to execute a "piggyback" agreement, i.e., a stipulation to be bound by the outcome of the test cases. The majority of petitioners in the Kersting-related cases executed piggyback agreements. See the discussion in *Gridley v. Commissioner*, *supra* note 5.

7. One nontest case petitioner, Denis Alexander, in exchange for his acting as a witness and serving as an undeclared consultant to McWade during the original trial of the test cases, as described in Dixon III at Findings of Fact V.B. and VI.F., received a settlement even more favorable than that afforded the Thompsons. Although the Court of Appeals in Dixon V noted Alexander's settlement, the Court of Appeals did not rely on or refer to that settlement in formulating the sanction to be imposed by its mandates.

II), respondent's senior management discovered the settlements, moved this Court to vacate the decisions (including the decisions in the Thompsons' cases) that had not already been appealed to the Court of Appeals for the Ninth Circuit, and requested an evidentiary hearing. After vacating the decisions, the Court denied the motion for evidentiary hearing, entered decisions for the Thompsons in accordance with their final settlement, and reentered or allowed to stand its decisions in the other test cases. The Court thereafter denied motions by test case and nontest case petitioners to intervene in the Thompsons' cases shortly before the new decisions in those cases became final. In *DuFresne v. Commissioner*, 26 F.3d 105 (9th Cir. 1994) (hereafter *DuFresne*), the Court of Appeals for the Ninth Circuit vacated the decisions against the other test case petitioners on the ground that the misconduct of Sims and McWade required further inquiry. The Court of Appeals directed this Court to hold an evidentiary hearing to determine: "whether the extent of misconduct rises to the level of a structural defect voiding the judgment as fundamentally unfair, or whether, despite the government's misconduct, the judgment can be upheld as harmless error." *Id.* at 108.

This Court conducted the evidentiary hearing directed by the Court of Appeals and held that the misconduct of the Government attorneys did not create a structural defect but rather resulted in harmless error. See *Dixon v. Commissioner*, T.C. Memo. 1999-101 (Dixon III). We imposed sanctions against respondent in the form of relief from the accrual of interest on additions to tax for

negligence as well as relief from additional interest under section 6621(d)/(c) (hereafter, section 6621(c)).[8]

The other test case petitioners again appealed. The Court of Appeals for the Ninth Circuit reversed and remanded our decisions in those test cases in *Dixon v. Commissioner*, 316 F.3d 1041 (9th Cir. 2003), as amended on March 18, 2003 (Dixon V). The Court of Appeals held that the misconduct of respondent's counsel constituted a fraud on the court and directed this Court to enter decisions "in favor of Appellants and all other taxpayers properly before this Court on terms equivalent to those provided in the settlement agreement with Thompson and the IRS." *Id.* at 1047. In this opinion, we determine the terms of the Thompson settlement and their application to the Kersting project participants before the Court.

FINDINGS OF FACT

The parties have filed a stipulation of facts for evidentiary hearing on September 20, 2004; a first supplemental stipulation of facts for evidentiary hearing on September 20, 2004; a second supplemental stipulation of facts for evidentiary hearing on November 22, 2004; a third supplemental stipulation of facts for evidentiary hearing on March 29, 2005; a fourth supplemental stipulation of facts, filed on June 17, 2005, and a stipulation of settled issues, filed on June 22, 2005. The facts stipulated therein

8. Sec. 6621(d) was redesignated sec. 6621(c) by the Tax Reform Act of 1986 (TRA), Pub. L. 99-514, sec. 1511(c)(1)(A)-(C), 100 Stat. 2744, and repealed by sec. 7721(b) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, 103 Stat. 2399.

are so found. The stipulation of facts and the attached exhibits are incorporated herein by this reference. The parties have further stipulated that, for purposes of the present opinion, the Court may incorporate its findings of fact as stated in earlier proceedings unless such facts are inconsistent with the opinion of the Court of Appeals in Dixon V or are inconsistent with facts stipulated or proven in proceedings held after the issuance of Dixon V.

I. *The Kersting Tax Shelters*

A. *Background*

All the cases before the Court concern proposed deficiencies, additions to tax, and interest that related to petitioners' participation in tax shelter programs promoted by Kersting. All the programs involved both "primary" loans and notes and "leverage" loans and notes with corporations organized by Kersting that have been held to be his alter egos. See *Kersting v. Commissioner*, T.C. Memo. 1999-197. These notes sometimes bore dates that were long before the date on which the documents were actually executed and even before the date on which the participant informed Kersting he was ready to participate in a particular program. Kersting advised participants in his programs that the programs created legitimate investments that would entitle participants to interest deductions that they should claim on their individual tax returns.

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B. *Respondent's Kersting Project*

1. *In General*

Kersting's promotion of his tax shelter programs had attracted the attention of the Internal Revenue Service (IRS), which instituted a tax shelter project known as the Kersting project.[9] In furtherance of that project, respondent sent deficiency notices to more than 1,800 taxpayers who had participated in the Kersting programs.

The IRS established the Kersting project in its Honolulu Appeals Office. In any given tax shelter project, a project Appeals officer typically works with a project attorney from the District Counsel's Office. In the Kersting project, McWade, from the Honolulu District Counsel's Office, served as the project attorney.

Once a tax shelter project is assigned to a particular District Counsel's Office, that District Counsel has the

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9. Tax shelter projects were initiated to deal with the large volume of cases generated by tax shelter examinations during the late 1970s and the early 1980s. Among the responses of the IRS and the Tax Court were the development of procedures, including tax shelter projects, that were intended to streamline the litigation process, economize on the use of administrative and judicial resources, and reduce the costs incurred by taxpayers in resolving disputes over tax shelter adjustments. The IRS, Office of Chief Counsel, created the Tax Shelter Branch in the National Office to oversee tax shelter litigation across the country and to organize individual tax shelter projects. The projects generally focused upon a specific type of tax shelter, such as those promoted by Kersting that constituted the Kersting project.

authority to settle any individual case in the project. The District Counsel generally is expected to adhere to the official project settlement offer. Nevertheless, the District Counsel has the authority in special circumstances to settle individual tax shelter project cases on a basis different from the project settlement offer.

2. *Bauspar*

One Kersting program that was not part of respondent's Kersting project was known as Bauspar. Kersting had promoted the Bauspar program as a combination savings and low interest mortgage plan. While the precise manner in which the Bauspar program operated for each participant remains uncertain, the total amount of home mortgage interest deducted by Bauspar participants appears to have been overstated.

Respondent's officials believed that there were relatively few participants in the Bauspar program, that there was no easy way to identify participants in the Bauspar program from a review of their income tax returns, and that an investigation of Bauspar deduction claimants would not be cost effective. Accordingly, respondent ultimately decided not to systematically pursue Bauspar participants through the Kersting project. Respondent's identification of Bauspar participants appears instead to have been a "hit or miss" proposition; although respondent has disallowed some Bauspar deductions claimed by a few Kersting project petitioners, those disallowances have been sporadic.

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Because the Bauspar program was not included in respondent's Kersting project, we refer to interest deductions claimed under the Bauspar program as Bauspar deductions rather than Kersting deductions.

C. *Respondent's Project Settlement Offer*

Between 1982 and 1988, respondent had in effect an official settlement offer for the Kersting project. In general, the offer permitted participants in the Kersting programs to resolve their cases by agreeing to pay income tax deficiencies that averaged 7 percent less than those determined in their deficiency notices. The offer also released participants from negligence additions and increased interest.

By September 1986, respondent's counsel had agreed to modify the 7-percent reduction settlement offer to incorporate a new feature, called the "burnout", that would apply in cases involving more than one taxable year. Under this procedure, the interest on a taxpayer's total unpaid deficiencies for the first and second years of tax liability would not begin to accrue until the return due date for the second year. The burnout thus postponed for a year the accrual of interest on the first year's deficiency, thereby reducing the total interest that accrued on the deficiencies. This was accomplished by zeroing out the taxpayer's agreed deficiency for the first year and adding it to the agreed deficiency for the second year.

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II. *The Thompsons' Participation in the Kersting Tax Shelters*

A. *The Thompsons' Tax Returns*

1. *Prepetition Years--1977 and 1978*

Although the Thompsons participated in one of Kersting's programs during 1977, they did not claim any Kersting-related interest deductions on their income tax return for that year, because their accountant refused to claim those deductions on the return.

The record suggests the Thompsons first claimed Kersting deductions on their 1978 tax return, which was prepared by an accountant recommended by Kersting.

2. *Years Before the Court*

1979

The Thompsons filed their 1979 tax return, pursuant to an extension, on May 29, 1980. The Thompsons reported Kersting deductions of $39,477 on that return.

1980

The Thompsons received an extension of time to file their 1980 tax return until June 15, 1981. On that return (received by the IRS on June 19, 1981), the Thompsons reported Kersting deductions of $72,840.

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1981

The Thompsons late filed their 1981 tax return on July 19, 1982, reporting Kersting deductions of $80,782 as investment interest expense. The Kersting deductions claimed on that return were the principal factor in reducing the Thompsons' adjusted gross income of $113,711 to taxable income of $18,685--a reduction of $95,026. The Thompsons also reported $8,000 of home mortgage interest expense that was probably attributable to the Bauspar program, in which the Thompsons began participating in April 1981.

3. *Years Following Those Before the Court*

1982

The Thompsons filed their 1982 tax return on May 6, 1983.[10] On that return, the Thompsons reported Kersting (and probably Bauspar) deductions sufficient to reduce their adjusted gross income of $99,364 to taxable income of $4,336--a reduction of $95,028. Neither petitioners nor respondent have been able to locate a copy of the Thompsons' 1982 tax return. The 3-year period of limitations under section 6501 expired with no action by respondent concerning the Thompsons' 1982 tax return.

1983

The IRS received the Thompsons' 1983 income tax return on July 2, 1984. The Thompsons reported no tax

10. By October 1982, Mr. Thompson had retired as a pilot with Continental Airlines.

liability on that return; they also reported Kersting interest expense deductions of $67,620 as well as Bauspar deductions.

1984

Respondent received the Thompsons' 1984 income tax return in April 1985. On that return, the Thompsons claimed Kersting interest expense deductions from two Kersting programs: "Mahaio" (Mahalo), in the amount of $4,320, and Federated Finance, in the amount of $3,420. The mortgage interest deduction included in the return also included interest paid pursuant to the Bauspar program. The Thompsons paid $2,269 as tax shown on the return to be owing.

1985

On their 1985 income tax return, the Thompsons reported itemized deductions of $37,932 and reported adjusted gross income of $22,507, resulting in zero taxable income. Although the Thompsons did not claim any Kersting deductions on the return, they overstated their mortgage interest expense as a result of their participation in the Bauspar program.

B. *Examination of the Thompsons' 1978-1981 Returns*

The Thompsons experienced audit problems with their 1978 tax return that were due, in part, to their failure to attach to the return a Form W-2, Wage and Tax Statement, showing the amount of income tax that

Continental Airlines had withheld from Mr. Thompson's wages. In early to mid-1986, the Thompsons' personal counsel, Samuel M. Huestis (Huestis), negotiated a settlement of their income tax liability for 1978. The record does not disclose the terms of that settlement.

On May 5, 1983, the Los Angeles District Director issued a statutory notice of deficiency with respect to the Thompsons' 1979 taxable year, disallowing Kersting deductions of $39,477 and determining a deficiency in tax of $18,161. The notice of deficiency also determined a negligence addition of $908 under section 6653(a). On July 11, 1983, the Thompsons filed a pro se petition in this Court seeking a redetermination of the deficiency and addition.

On June 13, 1984, the Honolulu District Director issued a statutory notice of deficiency with respect to the Thompsons' 1980 taxable year, disallowing Kersting deductions of $72,840 and determining a deficiency in tax of $24,838. On September 4, 1984, the Thompsons filed a pro se petition in this Court seeking a redetermination of the asserted deficiency.

On March 1, 1985, Kersting sent a letter to Kersting program participants stating that he had retained attorney Brian Seery (Seery) to represent them in the Tax Court at no charge to individual petitioners. The letter requested that each Kersting program participant provide written authorization for Seery's representation.[11] Seery's

11. In a letter to program participants dated Aug. 11, 1986, Kersting recommended that program participants not attempt to resolve their cases on their own and instead rely on counsel he had hired.

compensation for legal services rendered to Kersting program participants was always paid by one of Kersting's alter ego corporations. On March 20, 1985, Seery entered appearances for the Thompsons in their Tax Court cases for their 1979 and 1980 taxable years. He also entered his appearance for hundreds of other taxpayers.

On May 31, 1985, the Los Angeles District Director issued a statutory notice of deficiency with respect to the Thompsons' 1981 taxable year, disallowing claimed Kersting deductions of $80,782 and determining a deficiency in tax of $36,294.52. The notice of deficiency also determined negligence additions against the Thompsons under section 6653(a)(1) and (2), a late filing addition under section 6651(a)(1), and increased interest under section 6621(c). Respondent did not disallow the $8,000 claimed as home mortgage interest that was probably attributable to the Bauspar program. On August 13, 1985, the Thompsons filed a pro se petition in this Court seeking a redetermination of the asserted deficiency, additions, and increased interest for 1981.[12]

The Thompsons thus had three of their taxable years before the Court in three docketed cases. Respondent's determinations of the Thompsons' Federal income tax deficiencies and additions for their taxable years 1979-1981 were as follows:

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12. The Thompsons apparently filed their petition for their 1981 taxable year pro se, even after Seery had entered his appearance in the earlier cases.

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		Additions to tax			
Year	Deficiency	Sec. 6651(a)	Sec. 6653(a)	Sec. 6653(a)(1)	Sec. 6653(a)(2)
1979	$18,161	---	$908	---	---
1980	24,838	---	---	---	---
1981	36,295	$4,934	---	$1,958	50% of the interest due on the deficiency
Total	79,294	4,934	908	1,958	---

Respondent also determined that the Thompsons were liable for increased interest for 1981 pursuant to section 6621(c).

On November 21, 1985, the Chief Judge of this Court assigned all the Kersting project cases to Judge William A. Goffe (Judge Goffe) for trial or other disposition. Subsequent Kersting project cases were automatically assigned to Judge Goffe.

III. *The Test Case Litigation and the Thompson Settlements*

A. *Selection of the Test Cases*

McWade and Seery planned to use the test case procedure to dispose of the cases of the Kersting program petitioners who wished to contest the deficiencies determined against them by respondent. Most of these petitioners entered into stipulations of settlement for tax shelter adjustments, also called "piggyback agreements".

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Respondent and petitioners who entered into piggyback agreements thereby agreed to be bound by the results in the selected test cases. On June 10, 1986, McWade and Seery provided the names of the test case petitioners they had selected to Judge Goffe.

Seery and McWade had agreed to the selection of test cases in 14 dockets of seven married couples who had filed joint returns and one individual who had not filed jointly. Among the couples selected to be test case petitioners were the Thompsons, John R. and E. Maria Cravens (the Cravenses), and Richard and Fiorella Hongsermeier (the Hongsermeiers).

Seery particularly sought to include the Cravenses as test case petitioners because they treated their payments to Kersting as basis reductions that resulted in capital gain upon the termination of their interests in the programs. The Cravenses later decided to proceed without counsel and to settle their cases.[13]

Seery also selected the Hongsermeiers as test case petitioners because he mistakenly believed that they had used their own funds, rather than "nontaxable distributions" from Kersting corporations, to repay loans to other Kersting corporations. The Hongsermeiers' 1978-1980 taxable years were before the Court; respondent had failed to audit their 1981 and 1982 taxable years.

There is no clear indication whether it was Seery or McWade who originally proposed the participation of the

13. See *infra* note 23.

Thompsons. As noted, the Thompsons' 1979-1981 taxable years were before the Court. Respondent had failed to audit their 1982 taxable year.

B. *Deterioration of the Thompson-Kersting Relationship*

Around the time Seery and McWade selected the test cases, the relationship between the Thompsons and Kersting deteriorated. Earlier in 1986, the Thompsons' personal counsel, Huestis, had asked Kersting for an accounting of the Thompsons' participation in the Kersting programs. Huestis's request led to a dispute between the Thompsons and Kersting. On June 23, 1986, the Thompsons retained John Chanin, a Honolulu attorney, to help them in their dispute with Kersting. In a letter dated August 23, 1986, Kersting informed the Thompsons he had turned their file over to his own attorney for collection and further stated:

> The day after you have allowed your attorneys to file suit I will declare all notes which you have executed to our companies in default and begin collection proceedings. * * * The aggregate sum is well in excess of $250,000.00, as you know.
>
> * * * * * * *
>
> We will NOT provide legal assistance free of cost to you any longer in US Tax Court proceedings. You will have to retain your own attorney to make an appearance for you on February 9/1987 in US Tax Court.

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By letter dated August 24, 1986, Kersting notified Seery that he expected to be in litigation with the Thompsons and directed Seery not to "render any services, at our expense" to the Thompsons. On September 10, 1986, Huestis wrote to Seery, notifying him that the Thompsons were seeking substitute counsel and requesting their files. On September 15, 1986, Seery sent the Thompson files to Huestis and informed him that the Thompsons were test case petitioners. Seery indicated that he was withdrawing as the Thompsons' counsel.

On October 28, 1986, Huestis again wrote to Seery to express dissatisfaction with the sufficiency of the Thompsons' files and to warn Seery that his earlier representation of the Thompsons, while he was also apparently representing Kersting, could be viewed as a conflict of interest and lead to an action for "professional negligence". On October 31, 1986, Seery filed motions to withdraw as counsel in the Thompsons' cases, which the Court granted.

In ruling on a subsequent motion, Judge Goffe observed that there could be a conflict of interest if Seery represented both petitioners and Kersting. Seery subsequently filed motions to withdraw as counsel in the Kersting project cases (both test cases and nontest cases), citing concerns about a possible conflict of interest. The Court granted Seery's motions in November 1986.

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C. *The Thompsons Engage DeCastro, Who Settles Their Cases*

On or about November 15, 1986, the Thompsons retained attorney Luis DeCastro (DeCastro), who was also a certified public accountant, to settle their Kersting tax issues. Mr. Thompson retained DeCastro to resolve all the Thompsons' Kersting tax years, not only the 1979-1981 years docketed in the Tax Court. The Thompsons provided DeCastro with tax records for all those years. The retainer agreement between the Thompsons and DeCastro provided for a $5,000 fee, which covered only efforts to negotiate a settlement; it did not cover preparation for and conduct of a trial. None of the other petitioners in the Kersting project, whether test case petitioners or piggybackers, incurred any attorney's fees in connection with the preparation and trial of the test cases. Kersting paid all such fees.

Meanwhile, in the wake of Seery's withdrawal, Kersting engaged attorneys Robert J. Chicoine (Chicoine) and Darrell D. Hallett (Hallett) to represent the test case petitioners (other than the Thompsons and the Cravenses) at the Tax Court's trial session in Maui, Hawaii, which had been scheduled to commence February 9, 1987. Chicoine and Hallett agreed to do so with the understanding that they would not represent Kersting. In late 1986, Chicoine and Hallett apparently indicated to McWade and Sims that they intended to challenge the admissibility of evidence that had been seized in the January 1981 search of Kersting's office that became the subject of this Court's opinion in *Dixon v. Commissioner*, 90 T.C. 237

(1988) (Dixon I). See *supra* note 2. About the same time, McWade and Sims began to offer 20-percent reduction settlements that were based on the same general approach as their modified 7-percent reduction settlement offer that included the burnout feature.

In December 1986, DeCastro traveled to Hawaii on behalf of the Thompsons and a number of other clients who had participated in the Kersting shelters. There DeCastro, accompanied by Gary Poltash (Poltash), the Thompsons' new accountant, who was not associated with Kersting, began settlement discussions with McWade. Their initial agreement called for a reduction in the Thompsons' 1979-1981 deficiencies of approximately 18.8 percent. The settlement also provided for the elimination of all additions to tax and for the elimination of the increased interest rate under section 6621(c) for 1981. The burnout would also apply so as to combine the agreed deficiencies for the years 1979 and 1980 in the year 1980. During this trip, DeCastro and McWade also discussed the Bauspar program in which the Thompsons were involved.

On December 23, 1986, McWade signed and sent DeCastro stipulated decision documents in the Thompsons' cases. The transmittal letter stated that:

> As previously indicated, the Decision documents in John R. and Maydee Thompson will not be filed with the Court until the Decision becomes final in the test cases. In the interim, the Thompsons can make an advance payment, as discussed at our conference, and

stop the accrual of any additional liability for interest.

On December 30, 1986, DeCastro signed and returned to McWade the executed decision documents agreeing to the reduced deficiencies. Neither McWade nor Sims communicated the terms or existence of the Thompsons' settlement to their superiors.

The result of the pending settlement upon the Thompsons' tax liabilities would have been as follows:

Year	Income Adjustment	Determined Deficiency	Proposed Settlement	Percentage Reduction
1979	$39,477	$18,161	--	
1980	72,840	24,838	$34,425	
Total		42,999	34,425	20
1981	80,782	36,295	30,000	17
All years total		79,294	64,425	18.8

DeCastro, Poltash, and McWade had also agreed that the Thompsons would be able to deduct the interest payable on the deficiencies agreed to under the settlement by prepaying such interest by December 31, 1986.[14]

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14. The Internal Revenue Code was amended in 1986 to add a new sec. 163(h) that repealed the deduction for "personal interest". See TRA sec. 511(b), 100 Stat. 2246. Under the new sec. 163(h), 1986 was the last taxable year in which taxpayers could deduct 100 percent of such personal interest. TRA sec. 511(c), 100 Stat. 2249. For 1987, only 65 percent of personal interest was deductible, and the deduction for personal interest was phased out entirely by the end of 1989. Sec. 163(h)(6).

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As of December 31, 1986, the accrued interest on the Thompsons' newly settled deficiencies was $35,275.81 for 1980, and $24,270.62 for 1981--a total of $59,546.43, which the parties rounded to $59,545. Accordingly, the decision documents returned to McWade by DeCastro stated: "By separate cover you will also be receiving a check in the amount of $59,545 representing interest on the tax deficiencies reflected in the decision documents." With a letter dated December 30, 1986, Mr. Thompson sent McWade two checks: check No. 54 for $34,000, and check No. 242 for $25,545, for a total of $59,545. Mr. Thompson's letter stated: "I am at the present time doing the necessary procedures to take care of the balance."

At McWade's direction, IRS personnel in Honolulu prepared payment posting vouchers (Form 3244) allocating the Thompsons' prepayment of $59,545 between the 2 years before the Court, indicating designated interest for 1980 in the amount of $35,275.78 and designated interest in the amount of $24,269.22 for 1981. The entire amount of check No. 242 ($25,545) and $9,730.78 from check No. 54 was applied to 1980; the remainder of check No. 54 ($24,269.22) was applied to 1981. The Thompsons' $34,000 check (check No. 54) was subsequently dishonored. This was reflected as a debit for the Thompsons' accounts for 1980 and 1981. In February 1987, the Thompsons made a replacement payment of $34,340, representing the amount of the dishonored check plus a 1-percent bad check penalty. The replacement payment was restored as a credit as of December 31, 1986.

The Thompsons were the only test case petitioners for whom the IRS processed a prepayment of interest without

receiving a concurrent "advance payment on deficiency" to which the interest was attributable.

In January 1987, Chicoine and Hallett filed motions in this Court seeking to suppress the evidence that had been seized in the raids on Kersting's office and to shift to respondent the burden of proof and burden of going forward with evidence. The Chicoine and Hallett motions in effect turned the February 1987 Maui trial session into a hearing on the motions and resulted in a continuation of the trial of the test cases.

On March 13, 1987, McWade sent DeCastro a revised decision document for the Thompsons' 1980 taxable year, making a minor change that reduced the deficiency for that year from $34,425 to $33,000. McWade later explained: "It must have been I miscomputed something." With this modification of the settlement, the Thompsons' aggregate deficiencies for 1979-1981 were reduced by 20.55 percent of the deficiencies originally determined by respondent (i.e., from $79,294 to $63,000).

On June 15, 1987, DeCastro sent a $63,000 cashier's check "in partial payment of the total amount due" to the Internal Revenue Service Center in Fresno on behalf of the Thompsons. Respondent received the payment of $63,000 on June 17, 1987, and credited it to the Thompsons' 1979 account as an advance payment, less offset of a credit of $775 that was applied to their 1988 tax year. Accordingly, by June 1987, the Thompsons' payments to the IRS with respect to the taxable years 1979-1981 totaled $121,770 ($62,225 as an advance payment of tax, and $59,545 as interest).

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D. *IRS Activity Regarding the Thompsons' 1983-85 Returns*

In the meantime, an employee of respondent at the Fresno Service Center in California (with initials A.A.K.) prepared a statutory notice of deficiency (subsequently dated March 17, 1987) disallowing $67,620 of Kersting deductions claimed on the Thompsons' 1983 income tax return. Because the Thompsons had little taxable income that year, the first whole year of Mr. Thompson's retirement, the deficiency resulting from this disallowance was only $980. There is some indication that the notice of deficiency was mailed and that it caused an inquiry. An internal document of the IRS (Form 4700) reflects a handwritten entry dated May 8, 1987: "No reason to change determination – refiling case." Nevertheless, no petition for the Thompsons' 1983 taxable year was filed in this Court, and the deficiency was never assessed or collected.

On October 6, 1987, Revenue Agent Carolyn Speers (Speers), based in San Jose, California, audited the Thompsons' 1984 income tax return and noted $7,740 of Kersting deductions claimed on the return. On that date, she wrote the Thompsons a letter proposing to dispose of the Kersting issue identified on the return consistent with respondent's general 7-percent reduction settlement proposal. In her letter, Speers also requested additional information regarding the Thompsons' participation in the Kersting tax shelter programs, including a request for a copy of the Thompsons' 1985 income tax return.

Speers did not receive a response from the Thompsons to her October 6, 1987 letter nor to a followup letter dated November 17, 1987. On November 27, 1987, Mr. Thompson called Speers to report that he had forwarded her request to DeCastro.

On December 23, 1987, DeCastro sent Speers an executed copy of the 7-percent reduction settlement agreement for 1984, along with a power of attorney executed by the Thompsons for the taxable years 1984 and 1985, and a Form 872-A, Special Consent to Extend the Time to Assess Tax. Because DeCastro did not include the requested additional information or a copy of the Thompsons' 1985 return, Speers declined to proceed on the basis of the 7-percent reduction settlement. Instead, by letter to DeCastro dated January 12, 1988, Speers proposed to dispose of the Thompsons' 1984 year by disallowing the claimed Kersting interest expense deductions in their entirety. She again requested a copy of the Thompsons' 1985 return "to verify that interest from Kersting was not deducted in this year."

Beginning October 6, 1987, and continuing through February 24, 1988, Speers documented (in her case history worksheet) telephone or written contact in the course of her examination of the Thompsons' 1984 income tax return with the Thompsons, DeCastro, Philip Hoskins (of DeCastro's firm), and an accountant named "Rick." Speers's case history worksheet reflects no contacts with McWade, Sims, or any other of respondent's counsel.

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By letter dated February 22, 1988, DeCastro agreed to a complete disallowance of the $7,740 of Kersting deductions claimed by the Thompsons for 1984 and the resulting deficiency of $1,863. The Thompsons paid the deficiency and interest; by virtue of this disposition of the matter, respondent issued no notice of deficiency to the Thompsons for 1984.

On March 4, 1988, DeCastro sent Speers a copy of the Thompsons' 1985 income tax return. As noted above, the Thompsons' 1985 income tax return did not reflect any Kersting deductions (although it did include Bauspar deductions). In a letter dated March 25, 1988, Speers notified the Thompsons that she "was able to verify that interest from the Kersting project was not deducted" on that return. Respondent issued no notice of deficiency to the Thompsons for 1985.

E. *The Reporting and Resolution of the Thompsons' Deficiency Interest Payments for 1986 and 1987*

The Thompsons claimed their $59,545 interest payments to the IRS as an itemized interest deduction on Schedule A - Itemized Deductions of their 1986 income tax return. However, because their adjusted gross income for that year was relatively low, the Thompsons were able to use only $16,251 of the $59,545 deduction. The Thompsons did not claim any Kersting or Bauspar deductions on their 1986 return.

Poltash prepared the Thompsons' 1987 income tax return. On that return, the Thompsons deducted $27,914

as interest paid to the IRS. That figure represents 65 percent of $42,945. See *supra* note 14. Apparently, the Thompsons were attempting to carry over the unused portion of the interest deduction of $59,545 from their 1986 taxable year.[15] The Thompsons did not claim any Kersting or Bauspar deductions on their 1987 return. Poltash did not discuss the preparation of the Thompsons' 1986 or 1987 returns with McWade or Sims.

Revenue Agent Speers examined the Thompsons' 1986 income tax return. She asked about the $59,545 interest deduction in letters to the Thompsons dated February 26 and March 25, 1988. In a telephone conversation with Speers on May 23, 1988, Mr. Thompson explained the $59,545 interest expense deduction to her satisfaction. Speers closed the examination of the Thompsons' 1986 return without making any adjustments to the return. Her examination workpapers reflect her notation that "TP paid large interest to IRS on Schedule A--verified per transcripts."

In June 1989 a revenue agent[16] screened the Thompsons' 1987 income tax return for Kersting

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15. Although Poltash claimed to lack any recollection of his attempt to claim the interest deduction, he conceded the $42,945 amount might have represented an attempt to claim for 1987 the portion of the $59,545 claimed on the 1986 return that produced no tax benefit to the Thompsons. We note a slight discrepancy between the amount of the deduction actually used on the Thompsons' 1986 return ($16,251) and the figure underlying the $42,945 "carryover" for 1987 ($59,545 - $42,945 = $16,600).

16. The signature of the examining agent is difficult to decipher; it appears to be "Art (or Pat) Taylor."

deductions. The return bears a stamp stating "Income Tax Survey After Assignment", meaning that the agent saw nothing obvious for examination and returned the 1987 return to files without examining it or transmitting it for examination.

F. *The Thompson Settlement Revised as Trial Approaches*

Although Chicoine and Hallett ultimately recommended that their test case clients accept respondent's 20-percent settlement offer, Kersting disagreed and replaced Chicoine and Hallett with attorney Joe Alfred Izen, Jr. (Izen) in April 1988. Counsel on both sides began to prepare for trial, which was scheduled for January 1989 in Honolulu, Hawaii.

In an order dated August 30, 1988, the Court granted McWade's motion to depose Kersting. In October 1988, while in Honolulu for the Kersting deposition, DeCastro met McWade to discuss the Thompson cases. DeCastro told McWade he wanted to withdraw the Thompsons from the test case trial. DeCastro's reason for withdrawing the Thompsons was to avoid their having to pay the fees and expenses of the trial and to enable them to take the settlement they had already agreed to. McWade wanted to keep Mr. Thompson as a party to the trial because he was a test case petitioner who was represented by an attorney, DeCastro, who had not been hired and paid by Kersting. From respondent's standpoint, there was also a benefit to having, as a party witness, a participant in the Kersting program who was feuding with Kersting and could be expected to testify against him.

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Recalling the withdrawal of Seery, Sims was concerned by the potential conflict of interest from Kersting's paying the fees of the attorney representing the test case petitioners. Accordingly, he wanted to keep DeCastro in the trial of the test cases as an independent attorney, paid by the taxpayer, to provide an apparent safeguard against the trial appearing to be slanted toward protecting the promoter's (as opposed to petitioners') interest.

McWade and DeCastro also apparently discussed the status of an outstanding Federal tax lien on the Thompsons' house (unrelated to their participation in Kersting shelters), which the IRS had yet to remove more than a year after the Thompsons had satisfied the underlying liability.[17] On November 22, 1988, respondent issued a certificate of release with respect to the Federal tax lien on the Thompsons' house.

Shortly before trial of the test cases in this Court in January 1989, McWade and DeCastro reached an oral agreement (the new agreement) calling for reduced amounts of agreed deficiencies for 1979-1981 of zero, $15,000, and $15,000, respectively. The purpose of the reductions was to compensate the Thompsons for the cost of having an attorney represent them at the trial of the test cases. DeCastro estimated that his legal fees for representing the Thompsons at the trial of the test

17. Under sec. 6325(a)(1), the IRS was required to release the lien not later than Oct. 7, 1987, 30 days after the liability had been satisfied.

cases would be approximately $60,000.[18] It was estimated that the newly agreed reductions would generate approximately $60,000 of refunds to the Thompsons from the $121,770 they had paid earlier toward satisfaction of the deficiencies and interest under the earlier settlement. The new agreement also preserved the Thompsons' chances to prevail on the merits of the litigation. McWade and DeCastro agreed that if the results of the trial were more favorable to the Thompsons than the new agreement, the Thompsons would be entitled to the results of the trial.

When the new agreement was reached, respondent's official settlement policy still provided for a 7-percent reduction in determined deficiencies, elimination of the negligence penalty, and other minor concessions, although, as the time for trial approached, some nontest case petitioners' attorneys continued to negotiate 20-percent reduction settlements. The new agreement, however, reduced the Thompsons' deficiencies for the years at issue from the originally determined $79,294 to $30,000--a reduction of 62.17 percent. The new agreement substantially deviated from respondent's official settlement

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18. As petitioners point out, DeCastro was somewhat inconsistent in his recollection of his proposed billing. On June 2, 1992, he initially denied that the new agreement was designed as a mechanism for respondent to pay his fees, but he admitted to the contrary 8 days later. On Aug. 11, 1992, DeCastro recalled estimating that it would cost a minimum of $30,000 to try the Thompsons' case. After being shown documents indicating he had billed the Thompsons for more than $30,000, DeCastro said he had told McWade that his fees would be roughly $65,000. As respondent points out, DeCastro's bills to the Thompsons, as of Nov. 29, 1989, totaled $58,738.20.

policy and from the 20-percent reduction settlements obtained by DeCastro and Chicoine and Hallett and other attorneys on behalf of other clients. None of Sims's or McWade's superiors approved the new agreement. To the contrary, Sims's and McWade's superiors did not discover the new agreement until after this Court had tried the test cases, issued its opinion, and entered its initial decisions therein.

G. *Trial and Entry of Decisions*

The trial of the test cases was conducted before Judge Goffe from January 9 through January 27, 1989, at Honolulu, Hawaii. Neither Sims, McWade, nor DeCastro informed Judge Goffe, the National Office, the Regional Office, or Izen of the Thompson settlement or the Cravens settlement before or during the January 1989 trial of the test cases, or thereafter.

The Government paid the travel, food, and lodging expenses of Mr. Cravens and Mr. Thompson while they were in Hawaii. Mr. Thompson's reimbursed expenses amounted to $1,105.13. We stated in Dixon III, n.53: "Inasmuch as respondent subpoenaed all the test case petitioners, it is assumed they were all reimbursed for their expenses." Although there is no evidence in the record that any other test case petitioner, other than Mr. Cravens and Mr. Thompson, was reimbursed by the Government for the expenses of attending the test case trial, neither is there any record evidence that any or all of the other test case petitioners who requested reimbursement of their trial attendance expenses had their requests denied, or

indeed that requests for reimbursement were made by any such petitioners.

Around the time of the 1989 trial, DeCastro asked McWade to arrange for the Thompsons to receive a refund of $30,000 of their advance payments. In a memorandum dated April 10, 1989, McWade requested respondent's administrative officials to process a $30,000 refund to the Thompsons. On July 11, 1989, the Government issued a refund check of $30,000 to the Thompsons. The Thompsons endorsed the check to DeCastro Law Corp. without depositing it in their own checking account. The Thompsons did not claim a deduction on their 1989 return for the $30,000 they paid DeCastro.

On August 3, 1989, DeCastro wrote a letter to McWade confirming the revision of the Thompson settlement that had been agreed to before the trial of the test cases. DeCastro's letter states in pertinent part as follows:

> Re: Jack and Maydee Thompson
>
> Dear Ken:
>
> Please confirm following is our agreement with respect to settlement of above taxpayer's cases for open years:
>
> We have agreed that the total taxes due for all the open years are $15,000 for 1980 and $15,000 for 1981.

> Further, in the event a final decision in this case is more favorable they are to receive the benefit of such decision.
>
> Please sign below so I can have for my files.

McWade signed the letter and returned it to DeCastro.

On August 24, 1989, DeCastro wrote McWade requesting him to arrange for the Thompsons to receive the balance of their refund. McWade replied that the balance would not be released until the Tax Court had issued its opinion, and DeCastro so informed the Thompsons. DeCastro told the Thompsons that, because the IRS would be paying interest, he believed it was fair to add interest to the Thompsons' bill.

On or about November 6, 1989, McWade received an undated letter from Mr. Thompson, which stated in pertinent part as follows:

> Dear McWade:
>
> There are some questions in mind that I feel you can help me answer.
>
> * * * * * * *
>
> I received a check from IRS in the amount of thirty thousand dollars--($30,000). I endorsed this over to DeCastro Law Corp; this did not retire the billed amount. I am completely

> amazed at the billings we are receiving. I am now in receipt of additional billings that exceed realistic amounts. In fact the total comes to sixty six thousand two hundred forty three and 66/100 dollars ($66,243.66). At some point I know a reconciliation will come. Luis [DeCastro] says don't be concerned. I am very concerned, I am the one being billed.
>
> * * * * * * *
>
> Most emphatically I did not expect to be a channel through which IRS funneled funds to any law firm. Certainly not in this magnitude. I have the feeling at this point that I am correct in this--the bill is to [sic] much. I want to know the exact legal position I occupy. We have been frustrated long enough. We wish to close this chapter.

DeCastro wrote to Huestis on November 17, 1989, stating, in pertinent part:

> Thank you for your letter regarding the matter of the Thompsons' fees. As I have told Jack, we are looking for payment of his fees to the IRS, not him. I am enclosing a copy of my letter to him in this regard for your information.

DeCastro sent a similar letter to the Thompsons on the same date.

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On December 11, 1991, the Court issued its opinion in *Dixon v. Commissioner*, T.C. Memo. 1991-614 (Dixon II), sustaining almost all of respondent's determinations that the Kersting programs at issue lacked merit for tax purposes.

On March 13, 1992, the Court entered decisions against petitioners in the test cases in accordance with its opinion. On May 14, 1992, the test case petitioners--other than test case petitioner Ralph J. Rina (Rina) and the Thompsons and the Cravenses--appealed the decisions in their cases to the Court of Appeals for the Ninth Circuit.

H. *Discovery and Disclosure of the Thompson Settlements*

On May 8, 1992, Sims and McWade, by memorandum, requested the San Francisco Appeals Office to process the Thompsons' account administratively in accordance with the Thompson settlement, not the Tax Court's decisions. On May 22, 1992, Danny Cantalupo, Regional Director of Appeals for the Western Region, informed Peter D. Bakutes (Bakutes), Deputy Regional Counsel for Tax Litigation for the Western Region in San Francisco, of Sims's and McWade's request to process the Thompson settlement. Bakutes informed Benjamin Sanchez (Sanchez), the Western Regional Counsel in San Francisco, who informed officials in the National Office of the Office of Chief Counsel in Washington, D.C. The circumstances surrounding the Thompson settlement became a matter of widespread concern within the IRS.

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On May 29, 1992, Sims, at the direction of Sanchez, informed DeCastro by letter that the Thompson settlement would not be honored, and that assessments would be made in accordance with the decisions entered on March 13, 1993, pursuant to Dixon II. The letter advised that assessment of the taxes owing, plus statutory additions and interest, would be "approximately $302,396.12." The letter further noted: "Of course, your clients' advance payments will be credited toward the assessments."

DeCastro had several telephone conversations with respondent's officials, in which he maintained that the Thompson settlement, as memorialized in the August 3, 1989 letter agreement, was an enforceable contract, and that he was prepared to appeal any decision to the contrary.

Bakutes prepared a motion that was filed in this Court on June 9, 1992, seeking leave to vacate the decisions entered in the Thompson cases, as well as the Cravens and the Rina cases. Respondent requested the Court to conduct an evidentiary hearing to determine whether the agreements with the Cravenses and the Thompsons had affected the trial of the test cases or the ensuing decisions of the Court.

On June 10, 1992, Judge Goffe granted respondent's motions to vacate filed in the Thompson and the Cravens cases. That same day, Bakutes called DeCastro to tell him that the decisions in the Thompson cases had been vacated. During this call, DeCastro told Bakutes that in 1988 McWade had reduced the Thompsons' deficiencies to

keep the Thompsons in the case. Although he had earlier told Bakutes that attorney's fees were not awarded in the settlement, DeCastro admitted in this conversation that the deficiencies were reduced to pay the Thompsons' legal fees for his representation of them in the test case trial.

On or about June 11, 1992, Sanchez decided that Sims and McWade should no longer have any authority over the Kersting cases and that the cases should be assigned to other attorneys who had been involved in the Kersting project. Bakutes accordingly reassigned the 14 test case dockets to Thomas A. Dombrowski (Dombrowski) and the nontest cases to Henry E. O'Neill (O'Neill).

On June 22, 1992, Judge Goffe denied respondent's request for an evidentiary hearing and ordered the parties to file agreed decisions with the Court, "or otherwise move within 30 days of the date hereof."

In a separate order filed on the same date, the Court denied respondent's motion to vacate the decision filed in Rina's case, stating:

> The Court has reviewed the testimony of Cravens, the testimony of Thompson, the stipulated facts and stipulated exhibits relating to the Cravenses and the Thompsons, and the exhibits offered through Thompson as a witness. The Court finds that these reviewed items had no material effect on the opinion which the Court filed on December 11, 1991, as that opinion relates to petitioner Rina. If the

> reviewed items were stricken from the record, the Court would file an opinion in all material respects like the opinion it filed on December 11, 1991 (with the exception of certain portions relating specifically and expressly to the Cravenses or the Thompsons), and the Court's findings, analyses, and conclusions relating to petitioner Rina would remain the same. * * *[19]

During the summer of 1992, respondent's Acting Chief Counsel David Jordan (Jordan) directed two senior attorneys in the Tax Litigation Division in the National Office, Thomas J. Kane (Kane) and Steven M. Miller (Miller), to investigate the Thompson settlement on behalf of the National Office. Kane and Miller conducted in-house depositions and interviewed various individuals who had participated in the test case trial and the Thompson settlement.

Bakutes assigned Dombrowski to help Kane and Miller in their investigation. Dombrowski's immediate problem was how to respond to this Court's order of June 22, 1992, that the parties file agreed decisions with the Court or otherwise move within 30 days.

Dombrowski learned that McWade and Sims had denied that the purpose of the new agreement to reduce

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19. Rina appealed from this denial. Unlike the Thompsons, Rina had no settlement agreement with Sims and McWade. On June 13, 1995, Rina agreed to the entry of a stipulated decision in the amounts originally determined in his statutory notice of deficiency.

the Thompsons' deficiencies was to pay DeCastro's fees; instead, they claimed, the lowered deficiencies had something to do with the Thompsons' investment in Bauspar.[20] To see whether Bauspar figured in the Thompson settlement, Dombrowski sought the Thompsons' post-1981 tax returns. By July 13, 1992, he had received the Thompsons' 1983-89 returns and a memo that the Thompsons' 1982 tax return and administrative file had been destroyed. Dombrowski analyzed the returns to see if they shed light on the Bauspar question raised by McWade's and Sims's contentions. Although the 1982 tax return was not available, Dombrowski believed it likely that Kersting deductions had been claimed on that return because of the disparity between adjusted gross income and taxable income, and because Kersting deductions were claimed on the Thompsons' 1983 and 1984 returns. Dombrowski's "Analysis of Subsequent Year Returns" noted the mortgage interest deductions claimed on the Thompsons' 1983-85 returns and further noted "(Bauspar?)." He also noted that entries that may have reflected the Bauspar deductions had not been audited. Dombrowski's reason for putting a question mark after Bauspar was that he could not tell from the entries on the returns whether they actually related to Bauspar.

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20. In a memorandum dated Sept. 11, 1992, Kane had written: "Sims claimed that McWade had initiated the recommendation to allow Bauspar losses so that both Thompson and DeCastro would remain in the case. * * * Thus, Sims told McWade to work with the Bauspar numbers in order to give Thompson relief and keep him as a test case." (Fn. ref. omitted.) Additionally, in 1992, McWade testified that he reduced the Thompsons' deficiencies on his own to make up for the Thompsons' $80,000 "loss" in the Bauspar program. We found this testimony not credible.

Dombrowski also noted that the Thompsons appeared to have defaulted on a statutory notice issued to the Thompsons for 1983 disallowing claimed Kersting deductions of $67,620, but that the IRS had failed to assess the resulting deficiency of $980. Dombrowski also noted the May 8, 1987, entry in the Thompsons' file for 1983 that stated: "No reason to change determination – refiling case." Dombrowski believed this entry indicated that someone contacted the Fresno Service Center after receiving and questioning the notice of deficiency for 1983. Because the 3-year period of limitations with respect to the returns he was examining had expired several years earlier, Dombrowski did not attempt to determine why the assessment for 1983 had not been made. He instead focused on preparing a timely response to the Court's June 22, 1992, order in the Thompsons' cases.

On June 24, 1992, Marlene Gross (Gross), an official in the National Office of Chief Counsel, called Bakutes and informed him that, despite the disclosure of Sims's and McWade's misconduct, the Department of Justice (DOJ) would not seek to remand the test cases that had been appealed. The DOJ's decision was based on the Tax Court's refusal to vacate the decision in the Rina case. That refusal indicated to the DOJ officials that the Tax Court probably would not vacate its decisions in the other test cases if asked to do so. Gross also reported to Bakutes that the DOJ, and specifically, the Tax Division, Appellate Section Chief Gary Allen, wished to offer the same settlement to the test case petitioners on appeal that the Thompsons had received: A 65-percent reduction in deficiencies (an approximation of the reduction of the

Thompsons' originally determined deficiencies from $79,294 to the $30,000 figure finally agreed upon). Bakutes was opposed to settling the appealed cases on that basis. There is no evidence that the DOJ made any such settlement offer to the test case petitioners on appeal.

On July 16, 1992, DeCastro filed a motion for entry of decision in the Thompsons' cases, on the terms of his settlement agreement with McWade; i.e., deficiencies of zero, $15,000, and $15,000 for 1979-1981, respectively.

On August 20, 1992, respondent filed objections to DeCastro's motion for entry of decision, together with respondent's own motion for entry of decision. Respondent's motion sought a decision that reflected the original 18.8-percent reduction settlement agreed to by McWade and DeCastro in December 1986.[21]

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21. Respondent's motion stated that the December 1986 agreement between DeCastro, Sims, and McWade to reduce the Thompsons' deficiencies by 18.8 percent exceeded the terms of the standard 7-percent reduction settlement offer. Nevertheless, respondent conceded: "Respondent's counsel possessed the authority to make such an offer, and such offer was accepted by petitioners herein as well as others." Respondent also noted the "approximately 20 percent" reduction settlement offers previously made to other participants. Respondent's motion further indicates that Chicoine and Hallet's motion to suppress evidence was pending when McWade offered the 20-percent reduction settlement to DeCastro in December 1986. Although McWade may have known of Chicoine and Hallet's intent to file such a motion, the motion, in the form of a motion for leave to amend petition, was not filed until Jan. 12, 1987, after Chicoine and Hallett had entered their appearances. Any error in this regard, however, is immaterial, in view of our disposition of this matter.

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Respondent's 11-page motion for entry of decision, with a 15-page supporting memorandum, disclosed to the Court the facts that had been discovered in respondent's investigation. Respondent informed the Court that, before the test case trial, Sims and McWade had agreed to settle the Thompson cases by reducing the Thompsons' deficiencies in amounts sufficient to compensate the Thompsons for their projected attorney's fees. As respondent explained to the Court, Sims and McWade had agreed with DeCastro that

> All settlement refunds in excess of the amounts provided by the December 1986 agreement would go ultimately to the benefit of Mr. DeCastro for payment of his legal fees and costs. Mr. DeCastro would be paid solely from amounts refunded by the Service to Thompson. * * * This "New Agreement", in sum and substance, if not explicitly, was designed, and constituted an agreement by Messrs. Sims and McWade to pay Mr. DeCastro's legal fees and expenses.[22]

Respondent asserted that the new agreement was unauthorized and had no legal basis. If respondent's motion had been granted, the Thompsons' deficiencies

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22. On brief, petitioners question the assertions in respondent's motion that all settlement refunds "in excess of the amounts provided in the December 1986 agreement" would go to DeCastro. This assertion, however, appears to have reflected respondent's understanding at the time. Once again, in view of our disposition of this matter, any error in this respect is irrelevant.

would have been zero for taxable year 1979, $34,425 for 1980, and $30,000 for 1981.

On August 26, 1992, this Court granted DeCastro's motions for entry of decision in the Thompson cases, thus holding respondent to the pretrial concessions made by Sims and McWade in the new agreement:

Year	Deficiency	Additions to Tax
1979	---	---
1980	$15,000	---
1981	15,000	---

The Tax Court's decision for 1981 also relieved the Thompsons of the non-Kersting late filing addition of $4,934.32 under section 6651(a). That addition was the only non-Kersting issue in the Thompsons' docketed cases.

Respondent did not appeal the decisions entered by the Court with respect to the cases of the Thompsons and the Cravenses.[23]

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23. The Cravenses, who were not represented by counsel after Seery's withdrawal, had agreed with McWade to deficiencies of $9,782.16 for their taxable years 1979 and 1980, a reduction of only about 6 percent from the originally determined deficiencies of $10,401.45. This settlement was less favorable to them percentagewise than the generally available modified 7-percent reduction settlement offer and did not include the "burnout" feature. On Aug. 25, 1992, this Court entered a decision reflecting the Cravens settlement amounts, but the decision included the stipulation that certain advance payments made by the Cravenses had not yet been taken into account. Late in October 1992, officials

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The Office of Chief Counsel's rationale for not appealing the Tax Court's entry of the decisions giving effect to the Thompson settlement was set forth in a memorandum dated September 8, 1992, and signed by Kane:

> The Chief Counsel and Deputy Chief Counsel have concluded that, under the circumstances, we have completely fulfilled all applicable ethical and legal obligations with respect to this issue and this litigation. They have also concluded that given the fact that the conduct on the part of our attorneys is significantly less than exemplary, there is nothing to be gained by further prolonging this aspect of the Kersting litigation.

On September 30, 1992, Judge Goffe terminated his recall status as a Senior Judge and retired from the bench. The Chief Judge of the Tax Court reassigned the Kersting project cases to Judge Renato Beghe.

After this Court entered its decisions in the Thompson cases, Izen, who had represented the test case petitioners (other than the Thompsons and Cravenses) at the trial and who was representing them on their appeals, and Robert Patrick Sticht (Sticht), who represents a number of nontest case petitioners, filed separate motions with the Court to intervene in the Thompson and Cravens cases.

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in respondent's Western Region proposed closing the Cravenses' cases in such a way as "to cause the taxpayers' 1979 and 1980 accounts to zero out with no further amounts due."

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On November 6, 1992, the Court denied their motions to intervene, and Izen and Sticht filed notices of appeal.

I. *Implementation and Effects of the Final Thompson Settlement*

This Court's August 1992 decisions enforcing the final Thompson settlement had a number of financial consequences. The Court's decisions not only reduced the Thompsons' deficiencies; it also reduced the interest that had accrued on those deficiencies. In December 1986 and in January 1987, the Thompsons had paid $59,545 of interest on their originally settled deficiencies of $34,425 for 1980 and $30,000 for 1981. Because the Court's decisions giving effect to the new settlement agreement resulted in deficiencies of only $15,000 for each of 1980 and 1981, the interest that had accrued on those deficiencies before the Thompsons made their interest payments was much less than $59,545. Instead, as of December 31, 1986, the interest accruals on the $15,000 deficiencies for 1980 and for 1981 amounted to only $15,370.73 and $12,135.31, respectively. As a result, the Thompsons' aggregate payments of $59,545 in December 1986-February 1987 were more than sufficient to cover their total deficiencies and interest as eventually reduced by the final Thompson settlement.

In January 1993, respondent made new assessments against the Thompsons for 1980 and 1981 that were based upon the decisions entered by the Tax Court on August 26, 1992. The total assessments for 1980 and 1981 amounted to $57,506.04 (tax and interest for 1980 of $15,000 and

$15,370.73, respectively, plus tax and interest for 1981 of $15,000 and $12,135.31, respectively). Respondent applied the $59,545 credit balance resulting from the Thompsons' payments of $59,545 in interest to satisfy their $57,506.04 liability for 1980 and 1981, leaving a small credit balance.

The Thompsons' having remitted $63,000 in June 1987, in respect of their previously settled deficiencies, respondent credited $62,225 of that amount to their 1979 account as an advance payment of tax. Because the Thompsons had no deficiency for 1979 under both the earlier settlements and the Tax Court's decision giving effect to the new settlement, the $30,000 refund issued in July 1989 left a credit balance of $32,225. Accordingly, in February 1993, respondent issued a refund check for $32,225 to the Thompsons. As they had done with their earlier refund, the Thompsons endorsed this refund check to DeCastro, as payment of additional legal fees, without depositing the check in their own checking account.

DeCastro thereafter complained to Dombrowski that the Thompsons were entitled to receive even more from respondent. DeCastro argued that the Thompsons were entitled to receive interest on the $63,000 advance payment (albeit as successively reduced to $62,225 and then $32,225). Dombrowski requested "audit assistance", which he received from George Guzzardo (Guzzardo), an appeals auditor in respondent's San Diego office, in determining whether the Thompsons were entitled to the requested interest. Guzzardo determined that the Thompsons' $63,000 remittance on June 17, 1987, was an advance payment rather than a cash bond. The

distinction is important: An advance payment resulting in an overpayment entitles the taxpayer to interest on the overpayment; conversely, a cash bond does not earn interest. Having concluded that the previously refunded $62,225 was an advance payment, Guzzardo determined that the Thompsons were entitled to additional interest of $31,511.17 as of July 31, 1993. Dombrowski did his own computations, and then asked Jean Samuels (Samuels), an experienced appeals auditor, to check his and Guzzardo's figures. Samuels advised that in the main she agreed with both Guzzardo's and Dombrowski's calculations. Relatively small differences in their results were attributable to their use of different dates for the accrual of interest.[24]

On September 17, 1993, Dombrowski sent Bakutes a memorandum requesting approval to refund the interest on the Thompsons' overpayments, with a copy to the National Office. Bakutes approved the refund in an e-mail message to Dombrowski. In October 1993, respondent issued a refund check to the Thompsons in the amount of $32,116.68.

Finally, in December 1993, respondent issued a refund check of $4,107.93 to the Thompsons for 1980. The check represented an overpayment credit of $2,257.54 (the amount by which their $59,545 interest payment exceeded their deficiencies and interest for 1980 and 1981 after

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24. Samuels saw that the refund included some previously deducted interest, thus producing tax benefit income, but stated in her memorandum to Dombrowski, "Most taxpayers would probably either not know or not remember to include this [tax benefit income] in income, since they won't get a Form 1099 for it."

minor adjustments), plus accrued interest of $1,850.39 on the overpayment credit.

The Thompsons deposited these last two refund checks in their checking account.

The following table summarizes the payments by the Thompsons to respondent as well as the subsequent payments, as refunds and interest on refunds, by respondent to the Thompsons:

Paid by Thompsons:

$59,545	December 31, 1986 and February 17, 1987 payments of interest on deficiencies under original settlement.
62,225	June 1987 advance payment of deficiencies for 1979-1981 (net of $775 credited to tax year 1988).
121,770	Total amount paid for years in issue.

Received by Thompsons:

$30,000.00	Refunded July 11, 1989, pursuant to request of McWade, endorsed to DeCastro.
32,225.00	Refunded February 19, 1993, pursuant to request of DeCastro and endorsed to DeCastro.

32,116.68	Third refund check, dated October 22, 1993, for $32,116.68, representing interest on overpayment resulting from advance payment of deficiencies.
4,107.93	Refund, with interest, of overpayment resulting from application of $59,545 interest payment against 1980-81 deficiencies and interest.
98,449.61	Total amount refunded by IRS for years in issue.

In sum, the Thompsons were refunded $98,449.61 of the $121,770 they had paid in deficiencies and interest for 1979-1981. Of the $98,449.61 refunded, $81,225 was paid to DeCastro as legal fees. Of this amount, $62,225 was paid to DeCastro by the Thompsons' endorsement to him of the first two refund checks they received in 1989 and 1993. The Thompsons apparently paid DeCastro an additional $19,000 after receiving the third refund check later in 1993.

On their 1993 tax return, the Thompsons reported both the $32,116 interest income received from the IRS in October and the smaller interest payment of $1,850 received in December. Their return did not reflect the tax benefit arising from the fact that, while they deducted $44,165 of deficiency interest on their 1986 and 1987 returns ($16,251 for 1986 and $27,914 for 1987), the interest on the reduced deficiencies that were ultimately assessed in 1993 amounted to only $27,506 ($15,371 for 1980 and $12,135 for 1981). Pursuant to written advice from

DeCastro, the Thompsons deducted the fees paid to him in 1993 totaling $51,225 ($32,225 + $19,000) in computing their taxable income. The description accompanying the deduction claim on the Thompsons' 1993 return was "LEGAL FEES FOR INCLUDABLE INC."[25]

J. *Respondent's Disciplinary Action Against Sims and McWade*

On July 29, 1993, Sanchez sent notices of proposed disciplinary action to Sims and McWade. The notices asserted that Sims and McWade had violated: (1) Department of the Treasury Minimum Standards of Conduct, section 0.735-30(a)(2) (an employee shall avoid any action which might result in or create the appearance of giving preferential treatment to any person); (2) Department of the Treasury Minimum Standards of Conduct, section 0.735-30(a)(6) (an employee shall avoid any action that might adversely affect the confidence of the public in the integrity of the Government); and (3) IRS Rule of Conduct 214.5 (an employee will not intentionally make false or misleading verbal or written statements in matters of official interest). The notices proposed to suspend both Sims and McWade for 14 calendar days without pay.

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25. The reference to "INCLUDABLE INC." has not been satisfactorily explained, even by Poltash, whose office prepared the return. Petitioners urge that the reference is to "an entity that never existed." The Court doubts the reference is to an entity at all, but the Court's question to Poltash, whether the reference was a shorthand reference to "includable income", as a justification for deductibility under sec. 212, met with a protestation of ignorance.

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McWade retired from the IRS effective October 2, 1993. On November 2, 1993, Acting Chief Counsel Jordan approved Sanchez's proposed disciplinary action. Sims was suspended from duty without pay for 14 days and was transferred to the San Francisco Regional Counsel's Office, where he was assigned nonsupervisory duties as a Special Litigation Assistant in the General Litigation area.

IV. *Ninth Circuit Remand and Subsequent Proceedings*

A. *Ninth Circuit Orders in the DuFresne Case*

On June 14, 1994, the Court of Appeals for the Ninth Circuit filed a per curiam opinion, vacating and remanding this Court's decisions in the remaining test cases, on the ground that the misconduct of Sims and McWade required further inquiry. *DuFresne v. Commissioner*, 26 F.3d at 107. Citing *Arizona v. Fulminante*, 499 U.S. 279, 309 (1991), the Court of Appeals observed:

> We cannot determine from this record whether the extent of misconduct rises to the level of a structural defect voiding the judgment as fundamentally unfair, or whether, despite the government's misconduct, the judgment can be upheld as harmless error. * * *

Accordingly, the Court of Appeals remanded the remaining test cases to this Court with directions "to conduct an evidentiary hearing to determine the full extent of the admitted wrong done by the government trial lawyers." *Id.*

It further directed this Court to "consider on the merits all motions of intervention filed by parties affected by this case." *Id.* Finally, the Court indicated that "All subsequent appeals will be scheduled before this panel." *Id.*

Notwithstanding its general endorsement of allowing parties in related cases to intervene, the Court of Appeals for the Ninth Circuit dismissed attorneys Izen's and Sticht's appeals from this Court's denial of their motions to intervene in the Thompson and Cravens cases. In an unpublished opinion filed the same day as the *DuFresne* opinion, the panel of the Court of Appeals that had decided *DuFresne* explained:

> The Tax Court's August 25 and 26, 1992 decisions entering settlement in the *Cravens* and *Thompson* cases, respectively, are final. 26 U.S.C. § 7481(a)(1); Fed. R. App. P. 13. The Tax Court lacks jurisdiction to vacate those decisions. *Billingsley v. CIR*, 868 F.2d 1081, 1084 (9th Cir. 1989). Because there is no case remaining in which the taxpayers can intervene, this appeal is moot. [*Adair v. Commissioner*, 26 F.3d 129 (9th Cir. 1994).]

On September 29, 1994, the District Court for the District of Hawaii entered an order in favor of the United States that approved the assessment of penalties of $1,545,201 and $2,230,000 under sections 6700 and 6701 against Kersting for the promotion of abusive tax shelters. Kersting timely appealed.

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In December 1994, the Tax Court received the mandate of the Court of Appeals in *DuFresne*, and the test cases were assigned to Judge Beghe for further proceedings under the mandate.

B. *Evidentiary Hearing and Opinions After the Remand in DuFresne*

In response to respondent's motion for the evidentiary hearing required by the mandate, this Court, following receipt of the record from the Court of Appeals, set the test cases for a pretrial hearing to be held July 17, 1995. In furtherance of the Court of Appeals' directive regarding intervention, the Court ordered that notice of the hearing be served on all attorneys who had entered appearances on behalf of nontest case petitioners in the Kersting project. Ultimately, the Court ordered that 10 cases of nontest case petitioners, each represented by either Izen, Sticht, or attorney Robert Alan Jones (Jones), be consolidated with the remaining test cases for purposes of the evidentiary hearing. As a result, three groups of petitioners participated in all subsequent phases of the evidentiary hearing: Test case and nontest case petitioners represented by Izen; nontest case petitioners represented by Sticht; and nontest case petitioners represented by Jones.[26]

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26. The group of cases that were consolidated for purposes of the evidentiary hearing initially included the case of William D. and Karen S. Booth, docket No. 28950-88, in which Declan J. O'Donnell (O'Donnell) had entered his appearance. However, at the start of the evidentiary hearing, the Court granted O'Donnell's motion to sever the Booth case from the cases consolidated for the evidentiary hearing. O'Donnell argued that, in light of the

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As directed by the Court of Appeals in *DuFresne*, Judge Beghe conducted the evidentiary hearing at special trial sessions of the Court in Los Angeles, California, from May 13-30 and June 10-26, 1996, and August 18, 1997. On March 30, 1999, on the basis of the record developed at the evidentiary hearing, the Court issued its supplemental opinion in *Dixon v. Commissioner*, T.C. Memo. 1999-101 (Dixon III). The Court held that the misconduct of the Government attorneys in the trial of the test cases did not, in the words of the Court of Appeals for the Ninth Circuit in *DuFresne*, constitute a "structural defect" in the trial, but rather resulted in "harmless error". However, the Court imposed sanctions against respondent, holding that Kersting program participants who had not had final decisions entered in their cases would be relieved of liability for (1) the interest component of the addition to tax for negligence under section 6653(a)(1)(B) and (2), and (2) the incremental interest attributable to the increased rate prescribed in section 6621(c).

On March 13, 2000, the Court of Appeals for the Ninth Circuit affirmed the order of the Hawaii District Court that had imposed almost $3 million in penalties against Kersting for the promotion of abusive tax shelters. The opinion of the Court of Appeals states:

> The district court did not err in finding that Kersting knew or had reason to know that

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theory underlying a motion for summary judgment that he had filed on behalf of the Booths, they had no need to participate in the evidentiary hearing. In *Gridley v. Commissioner*, T.C. Memo. 1997-210, the Court denied O'Donnell's motions for entry of decision consistent with the final Thompson settlement.

> his statements concerning the allowability of interest were false or fraudulent. See 26 U.S.C. § 6700(a)(2); * * *. The record indicates that Kersting knew that his tax shelters were sham transactions in which participants could write off approximately twelve dollars for every dollar of actual out-of pocket expenses. Kersting himself indicated in a 1977 "comfort letter" to one of the "nervous nellies" investing in his scheme that these deductions were not legitimate - Kersting warned the individual to "be sure this letter does not get into the wrong hands. If IRS would become aware of the offsetting character of your note you would likely lose your interest deduction".
>
> Kersting also knew that these fraudulent interest deductions originating in a prior version of his tax shelter had been previously disallowed by this Court. See *Pike v. Commissioner*, 78 T.C. 822 (1982) (denying interest deductions to taxpayers participating in Kersting's tax shelters because the transactions conducted by Kersting's corporations were shams lacking economic substance), affd., 732 F.2d 164 (9th Cir. 1984). After *Pike*, Kersting made merely cosmetic changes to his tax shelter scheme. * * *

Kersting v. United States, 206 F.3d 817, 819 (9th Cir. 2000).

On March 31, 2000, this Court issued a supplemental opinion, *Dixon v. Commissioner*, T.C. Memo. 2000-116

(Dixon IV), awarding petitioners some of the attorney's fees they sought for services performed in the evidentiary hearing mandated by the Court of Appeals in *DuFresne* and denying their motions for additional sanctions. In so doing, the Court denied petitioners' requests for the award of attorney's fees under section 7430, on the ground that Dixon III had held that none of them was a "prevailing party" as defined in section 7430(c)(4). Instead, the Court awarded fees under section 6673(a)(2), which authorizes the Tax Court to require the United States to pay excess costs, expenses, and attorney's fees whenever the Commissioner's attorneys have "multiplied the proceedings in any case unreasonably and vexatiously".

On the same date, the Court entered decisions in the test cases, and the test case petitioners appealed. The Court also certified for interlocutory appeal the cases of nontest case petitioners represented by Izen, Jones, and Sticht who had also participated in the evidentiary hearing and nontest case petitioners represented by O'Donnell whose cases were the subject of the Court's opinion in *Gridley v. Commissioner*, T.C. memo. 1997-210. These nontest case petitioners also appealed.

C. *The Ninth Circuit's Opinion and Mandates in These Cases*

On November 21, 2001, following extensive motion practice on jurisdiction and other issues, the Court of Appeals set a briefing schedule and confirmed that the cases on appeal would be scheduled before the panel that issued the *DuFresne* opinion. Following receipt of

opening and reply briefs from test case petitioners,[27] now represented by three sets of attorneys,[28] the *DuFresne* panel filed an order indicating that, upon reconsideration, it would not retain jurisdiction, and directing the Clerk to schedule the appeal in the normal course of events. On October 10, 2002, the panel that ultimately issued the opinion in Dixon V heard oral argument in the test cases.

On January 17, 2003, the Court of Appeals issued its opinion in the test cases in *Dixon v. Commissioner*, 316 F.3d 1041 (9th Cir. 2003), amended on March 18, 2003 (Dixon V), vacating and remanding the Court's decisions in the test cases, and directing the further proceedings that have resulted in this opinion. Citing *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238, 247 (1944), overruled on other grounds *Standard Oil v. United States*, 429 U.S. 17, 18 (1976), the Court of Appeals stated: "There can be no question here but that the actions of McWade and Sims amounted to a fraud on both the taxpayers and the Tax Court." *Dixon v. Commissioner*, 316 F.3d at 1046. The Court of Appeals held that "fraud on the court" occurs regardless of whether the opposing party is prejudiced. *Id.*[29]

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27. On Nov. 20, 2001, the *DuFresne* panel had filed an order directing that the appeals of nontest case petitioners represented by Izen, Sticht, Jones, and O'Donnell "shall be held in abeyance pending resolution of the appeal in No. 00-70858" (i.e., the test cases).

28. The three sets of attorneys are Izen, Michael L. Minns, and John A. Irvine and Henry G. Binder.

29. The Court of Appeals acknowledged the contrary holding of the Court of Appeals for the Seventh Circuit in *Drobny v.*

The Court of Appeals further stated:

> We have the inherent power to vacate the judgment of the Tax Court, fashion an appropriate remedy, and sanction a party or its lawyers for willful abuse of the judicial process, particularly when the party or its lawyers have intentionally practiced a fraud upon the Court. * * *
>
> * * * The taxpayers should not be forced to endure another trial and the IRS should be sanctioned for this extreme misconduct.
>
> Conversely, we will not enter judgment eradicating all tax liability of these taxpayers. Such an extreme sanction, while within the court's power, is not warranted under these facts. * * *

Id. at 1047 (citations omitted). The Court of Appeals instead reversed the decisions of this Court in the test cases and directed this Court to "enter judgment in favor of Appellants and all other taxpayers properly before this Court on terms equivalent to those provided in the settlement agreement with Thompson and the IRS." *Id.* It left "to the Tax Court's discretion the fashioning of such

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Commissioner, 113 F.3d 670 (7th Cir. 1997), affg. T.C. Memo. 1995-209. In *Drobny*, the Seventh Circuit held that proof of fraud on the court requires a showing that the alleged misconduct actually affected the outcome of the case to the taxpayer's detriment. *Id.* at 678-679.

judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided for in the Thompson settlement." *Id.* n.11.

On January 21, 2003, respondent's then Chief Counsel, referring to Dixon V, publicly announced: "We will * * * assure that no interest is charged on deficiencies for the period of the appeals to the Ninth Circuit."[30]

On February 3, 2003, Deborah Butler, respondent's Associate Chief Counsel for Procedure and Administration, issued a Chief Counsel notice (CC-2003-008), reminding all Chief Counsel attorneys, in light of the opinion of the Court of Appeals in Dixon V, "to adhere to the highest ethical standards when performing their duties, including when representing the IRS before the Tax Court."

On March 14, 2003, the Court of Appeals issued orders remanding to the Tax Court for further proceedings consistent with the opinion in Dixon V the nontest cases that had been appealed pursuant to their certification for interlocutory appeal. On April 23, 2003, the Court of Appeals issued its mandates with respect to the test cases in accordance with Dixon V.

D. *Proceedings Following Remand*

On April 30, 2003, respondent filed a motion for a status conference regarding disposition on remand of

30. The original decisions in Dixon II were entered Mar. 13, 1992; the notices of appeal were filed May 14, 1992; the 90-day appeal period would have expired June 11, 1992.

the test cases and a group of related nontest cases. On May 1, 2003, this Court ordered the parties to file status reports regarding subsequent disposition of the cases. The responses displayed various disagreements between respondent and petitioners concerning not only the scope of the remedy, but the manner of its implementation. For example, the status report of petitioners' counsel Henry Binder states: "Respondent does not come to this Court's fashioning of the equitable remedy ordered by the Ninth Circuit with clean hands and, therefore, has no standing to argue the terms or scope of that remedy."[31] The Court conducted status conferences in Houston, Texas, in August 2003 and in Los Angeles, California, in September 2003 to address petitioners' attempts to settle the cases. The conferences resulted in no settlement.

The parties then engaged in protracted motions practice regarding assertions of privilege by respondent as to some matters sought in discovery and regarding the award of attorney's fees claimed by counsel for petitioners.

On April 5, 2004, petitioners filed motions for an evidentiary hearing. Thereafter, at the behest of the parties, the Court directed further discovery and conducted further hearings. The first hearing took place at Las Vegas, Nevada, in September 2004, the second

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31. Having considered certain issues raised in the status reports, this Court issued an order dated June 12, 2003, indicating it was "not inclined to consider attempts to disqualify counsel" in any of the cases at issue. We additionally stated: "This Court is not inclined to seek appointment of counsel from the United States Department of Justice to represent respondent in these cases".

hearing at Los Angeles, California, in November 2004, and the final hearing at Washington, D.C., in March 2005. By the end of September 2005, the parties had filed their briefs regarding the scope and application of the Thompson settlement.

E. *Further Disciplinary Proceedings*

On April 1, 1999, the day immediately following the issuance of the Dixon III opinion, Judge Beghe referred the misconduct of Sims, McWade, and DeCastro to the Committee on Admissions, Ethics, and Discipline of the Tax Court for disciplinary action.[32] In accordance with the Court's practice in such matters, the referrals were not mentioned in the Dixon III opinion or otherwise publicized when that opinion was issued.

On April 22, 2003, the Court, through the Committee on Admissions, Ethics, and Discipline, issued orders to Sims, McWade, and DeCastro to show cause why they should not be suspended or disbarred from practice before the Court or otherwise further disciplined. On July 1, 2003, DeCastro resigned from practice before the Court.

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32. On June 26, 1996, at what then seemed to be the close of the evidentiary hearing, Izen had filed a motion requesting this Court to refer the Thompson and Cravens settlements and McWade's settlement with Denis Alexander to the DOJ (Public Integrity Section) for criminal prosecution. Izen identified approximately 17 alleged crimes associated with these settlements. By order dated June 26, 1996, the Court denied Izen's motion.

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Following complaints filed by petitioners' counsel Minns in response to inquiries by the Dixon V panel at oral argument, the Arkansas State Bar suspended Sims's license to practice for 1 year in February 2004, and the Oregon State Bar suspended McWade's license to practice for 2 years in August 2004. This Court, acting on the orders to show cause and the recommendations of the Committee on Admissions, Ethics, and Discipline, suspended McWade and Sims from practice for 2 years, commencing February 20, 2004.[33] The Director of the IRS Office of Professional Responsibility suspended McWade and Sims indefinitely from practice before the IRS, effective June 9, 2004.

Under Rule 202(c)(1), a practitioner who has been suspended for more than 60 days or disbarred from practice before this Court may not resume practice until reinstated by order of the Court. Under Rule 202(c)(2), if the disciplinary proceeding giving rise to a suspension or disbarment was predicated upon the complaint of a Judge of this Court, a hearing on the petition for reinstatement is to be held before a panel of three other Judges appointed by the Chief Judge. At the hearing on the petition:

> the practitioner shall have the burden of demonstrating by clear and convincing evidence that the practitioner has the moral qualifications,

33. The first announcement by the Court with respect to the referrals was the Court's issuance, on Feb. 20, 2004, of a press release that disciplinary action had been taken against McWade and Sims. DeCastro's resignation was not publicized by the Court until issuance of the opinion herein.

> competency, and learning in the law required for admission to practice before this Court and that the practitioner's resumption of such practice will not be detrimental to the integrity and standing of the Bar or to the administration of justice, or subversive of the public interest. [*Id.*]

OPINION

Preliminary Comments

The Court of Appeals has directed that the remaining test case petitioners "and all other taxpayers properly before this Court" receive judgments in their favor "on terms equivalent to those provided in the settlement agreement with Thompson and the IRS." *Dixon v. Commissioner*, 316 F.3d at 1047. The Court of Appeals has left to this Court's discretion "the fashioning of such judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided in the Thompson settlement." *Id.* n.11.

Throughout the proceedings required to implement the mandates of the Court of Appeals, petitioners, impelled by outrage and indignation at the fraud on the Court committed by respondent's attorneys, seem to view the mandates as an invitation to award damages against respondent. Without in any way minimizing the seriousness of the misconduct of respondent's attorneys,

we decline any such invitation.[34] The mandates do not call for the recovery of damages by the taxpayers; they call for sanctions against respondent, to be determined in accordance with the ascertainable standard provided by the Dixon V opinion.

We now broach how, in light of the different circumstances of the Thompsons and the various groups of affected taxpayers, we can follow and apply the directive of the mandates. Interpreting the term "same position" used in footnote 11 of Dixon V to mean "same financial position", it might seem, at first blush, that the test case and nontest petitioners cannot be put in the financial position the Thompsons found themselves in as a result of the Thompson settlement. The Thompson settlement was embodied in a sequence of payments and refunds that occurred more than 15 to 20 years ago, when personal interest was fully or partially deductible for income tax purposes, in a different interest rate environment, and in temporal relationships that are not now reproducible with respect to any of the other petitioner participants in the Kersting project. Also, the bulk of those refunds was used to pay legal fees the other test case petitioners were not required to pay for representation in the test case trial.

It should be borne in mind that the Thompson settlement occurred in two distinct phases: In December 1986 into early 1987, McWade and DeCastro arranged to provide the Thompsons a reduction of approximately

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34. In any event, we lack jurisdiction to award damages. *Chocallo v. Commissioner*, T.C. Memo. 2004-152.

20 percent in the originally determined deficiencies; this version of the settlement took account of respondent's increased litigation risk resulting from Chicoine and Hallett's efforts to suppress the evidence discovered in the IRS raid on Kersting's office. Other Kersting petitioner clients of DeCastro and Chicoine and Hallett obtained 20-percent reduction settlements from McWade prior to the Court's 1988 opinion in Dixon I, and some other nontest case petitioners thereafter obtained such settlements. The Thompsons' payments to the IRS in late 1986 and in 1987 were made to satisfy their obligations under the approximately 20-percent reduction settlement arranged by McWade and DeCastro.

DeCastro thereafter played on the fears of Sims and McWade that he would walk away from the test case trial to extort the additional reduction agreed to in late 1988 and early 1989 that would generate the refunds that were to be used to pay his fees for providing legal representation to the Thompsons at the trial. The new Thompson settlement had no rationale quantifiably related to the hazards of litigation or the merits of the case; it was based on the opportunistic estimates of McWade and Decastro of what was needed to bring about a particular financial result that has little or no congruence with the situation in which the petitioners before the Court now find themselves. The fact that the Thompsons had already made the payments required by the earlier 20-percent reduction settlement provided the fund that was ripening for the taking under the new settlement. As it turned out, the overall reduction of approximately 62 percent in the

Thompson deficiencies provided by the new settlement was more than enough to produce the approximately $60,000 of refunds McWade and DeCastro thought would be needed to pay DeCastro's original estimate of what his fees would be. As it further turned out, the additional interest on the Thompsons' payments under the original settlement was sufficient to provide DeCastro with an additional fee that he (and perhaps Mr. Thompson) probably felt was justified by his success in keeping the new settlement in effect, as well as leave a surplus to be retained by the Thompsons.[35]

Test case and nontest case petitioners in the main fall into two groups, both of which are now in different situations from the situation of the Thompsons 15-20 years ago. It is the Court's impression that a substantial majority of nontest case petitioners are in the unhappy situation of having followed Kersting's advice to stand pat. They neither settled their cases nor made any remittances in respect of the deficiencies determined against them. With the passage of years and the operation against them of the force of compound interest, they claim that they have been facing financial ruin, with all its attendant anxieties; this is because they did not have the foresight or the discipline to invest the chimerical tax savings they had appropriated by using the Kersting shelters to support

35. The lack of legal rationale and the opportunistic character of the new settlement are emphasized by the fact that it was entered into after the litigation risk that supported the original 20-percent reduction settlement had evaporated with the publication of this Court's opinion in Dixon I.

their original return positions.[36] On the other hand, there are a minority of petitioners who, without conceding their liabilities, have stopped the running of interest against themselves by prepaying the Kersting deficiencies the IRS had determined against them.[37] With the passage of time and the operation in their favor of the force of compound interest, this minority of petitioners are entitled, under the Dixon V opinion and mandates, to substantial refunds, and properly so.

A further comment: The financial burden of petitioners who did not prepay has been substantially ameliorated--but not completely eliminated--by respondent's concession that no interest will be charged on deficiencies for the period of the appeals to the Ninth Circuit. That concession, prompted by respondent's recognition of responsibility for the delay in resolving the Kersting project cases caused

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36. The bulk of petitioners in the Kersting project appear to have been commercial airline pilots. There is no evidence in the record of their financial sophistication or lack thereof, either individually or as a group.

37. The Court understands that this group includes the remaining test case petitioners, with the exception of the Dixons, who received a discharge in bankruptcy. By collecting the deficiencies from the test case petitioners because of their failure to file appeal bonds, cf. *Estate of Kanter v. Commissioner*, T.C. Memo. 2006-46, respondent has put those petitioners in the advantageous position of being entitled to collect substantial refunds, on which interest has been accruing and compounding over the years without attracting current annual tax liabilities. Of course, the interest component of those refunds will be includable in gross income of the recipients when finally paid.

by the need to investigate the misconduct of respondent's attorneys, seems appropriate, but also generous. Even if there had been no misconduct by respondent's attorneys, the appeals filed by test case petitioners, before the misconduct was discovered, would have taken some substantial time beyond June 1992 to resolve. The amelioration is substantial because it has stopped the further accrual and compounding of interest on the deficiencies for more than 13 years. The amelioration is not complete because many petitioners have deficiencies going back to the late 1970s and early 1980s.

The bottom line is that, in the absence of the misconduct, petitioners who did not prepay would have been required to pay substantially more than they will be required to pay under the mandates. Moreover, they will be entitled to pay these reduced amounts many years later than would have been necessary if there had been no misconduct. As a result of respondent's concession, they have had the use of the money due for their reduced deficiencies for more than 13 additional years. Stated differently, they have enjoyed for more than 13 years the equivalent of an interest-free loan of the reduced deficiencies and interest they will now have to pay.

In sum, this Court has determined the terms of the Thompson settlement. Our decisions in these cases will apply those terms to test case and nontest case petitioners alike. Subject to the review of the Court of Appeals, our opinion and decisions will provide the template for the disposition of the more than 1,300 pending cases in the Kersting project.

Appendix B

The thoughts underlying the foregoing comments have informed our effort not only to determine and apply the terms of the Thompson settlement, but also our effort to put petitioners, to the extent possible and practicable, in positions similar to that provided by the Thompson settlement. Although it may be impossible to put petitioners in the same position, financial or otherwise, the Thompsons were in 15 to 20 years ago, we observe that the Code provisions for interest on deficiencies and overpayments,[38] in which are embedded the time value of money principles that underlie all financial planning,[39] provide the only available appropriate means of approximating the desired equivalence.[40]

For two reasons, those petitioners who prepaid will receive refunds many times greater than the Thompsons received: Most of those petitioners probably made payments equal to their originally determined deficiencies, not just 80 percent thereof, like the Thompsons, and their refunds will be exponentially increased by interest accruals because they have had to wait much longer than the Thompsons did to receive their refunds.

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38. Secs. 6601, 6611.

39. See generally, e.g., Brealey & Myers, Principles of Corporate Finance (7th ed. 2003).

40. Gokhale & Smetters, "Measuring Social Security's Financial Outlook within an Aging Society", Daedalus 91-92 n.2 (Winter 2006), comment that discounting to present value, an operation integral to giving effect to the time value of money, makes it possible "to place dollars accruing at different points in time on an equal valuation scale".

On the other hand, those petitioners who, unlike the Thompsons, did not prepay will have deficiencies that will be reduced in the same proportion as the Thompsons' deficiencies were finally reduced under the settlement. Although they will still have to pay those reduced deficiencies with interest accruing until mid-1992, their interest obligation will have been substantially reduced by respondent's concession. We conclude these comments by again observing that these petitioners will still be substantially better off financially than they would have been in the absence of respondent's misconduct. And so should it be, in accord with the sanction the Court of Appeals has fixed as the appropriate judicial response to the misconduct of respondent's attorneys.

I. *Procedural Issues Following Remand*

A. *Procedural Posture*

These cases are before the Court pursuant to the *DuFresne* and Dixon V opinions and mandates of the Court of Appeals for the Ninth Circuit. They therefore present issues in a procedural posture diametrically different from the standpoint from which we usually redetermine income tax deficiencies or overpayments arising from notices of deficiency or refund claims. Here, the traditional roles of petitioner and respondent are reversed. In this phase of the proceedings, it is respondent, not petitioner, whose activities are being questioned. It is respondent, not petitioners, who is charged with having the necessary records and the personnel who have recollections

regarding the matters at issue.[41] Because of the unique posture of this case, it is respondent, not petitioner, who often argues that a deduction has been properly claimed and allowed (and thus should not be included as one of the taxpayer benefits of the Thompson settlement), while petitioners argue the contrary.

B. *Law of the Case*

The Court of Appeals for the Ninth Circuit recently explained the law of the case doctrine as follows:

> "The law of the case doctrine requires a district court to follow the appellate court's resolution of an issue of law in all subsequent proceedings in the same case." *United States ex rel. Lujan v. Hughes Aircraft Co.*, 243 F.3d 1181, 1186 (9th Cir. 2001). The doctrine applies to both the appellate court's "explicit decisions as well as those issues decided by necessary implication." *United States v. Cote*, 51 F.3d 178, 181 (9th Cir. 1995) (quoting *Eichman v. Fotomat Corp.*, 880 F.2d 149, 157 (9th Cir. 1989)). * * * [*Al-Safin v. Circuit City Stores, Inc.*, 394 F.3d 1254, 1258 (9th Cir. 2005).]

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41. It should be noted that, following the remand in Dixon V, neither side called DeCastro, Mcwade, or Sims as a witness. We understand that DeCastro is seriously ill, so he was not available. We have no such information about McWade or Sims; perhaps their previous failures to persuade this Court of their credibility discouraged both sides from calling them.

In relying upon its inherent authority to sanction the IRS by extending the benefit of the Thompson settlement to all interested parties, the Court of Appeals by necessary implication concluded that the doctrine of inherent authority trumps the doctrine of sovereign immunity (the latter generally prohibiting the imposition of monetary sanctions against the United States absent the express consent of Congress).[42] We therefore are not concerned with that issue.

C. *Parties Before the Court*

The opinion of the Court of Appeals directs this Court "to enter judgment in favor of Appellants and all other taxpayers properly before this Court". *Dixon v. Commissioner*, 316 F.3d at 1047. In a technical sense, the Dixon V opinion and the implementing mandates might be deemed to extend only to those parties who filed notices of appeal. See *Abatti v. Commissioner*, 859 F.2d 115, 120 (9th Cir. 1988). We believe, however, that the Court of Appeals did not intend a technical, restricted application of its opinion and mandates, nor, apparently, do the parties. Following the hearings in these cases, the parties filed a stipulation of settled issues. Among other things, that stipulation recites:

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42. The principle that a court has inherent power to impose sanctions is well established. "It has long been understood that '[c]ertain implied powers must necessarily result to our Courts of justice from the nature of their institution,' powers 'which cannot be dispensed with in a Court, because they are necessary to the exercise of all others.'" *Chambers v. NASCO*, 501 U.S. 32, 43 (1991) (quoting *United States v. Hudson*, 11 U.S. (7 Cranch) 32, 34 (1812)).

> 1. The Kersting deficiencies of any petitioner who has filed a piggyback agreement with the Tax Court shall be determined in accord with the Ninth Circuit's mandates as implemented by the Tax Court on remand in this proceeding * * *.
>
> 2. The Kersting deficiencies of any petitioner in a case docketed before the Tax Court who has not filed a piggyback agreement will, absent a showing of cause, be determined in accord with the Ninth Circuit's mandates as implemented by the Tax Court on remand in this proceeding * * *.

We read these stipulations to apply to all open cases of petitioner participants in the Kersting tax shelter programs. In other words, the parties have agreed--and properly so--that the sanction applies to benefit not only to test case petitioners, but also to nontest case petitioners in all remaining docketed cases in the Kersting project, whether or not they signed piggyback agreements.

D. *Burden of Proof*

In our Dixon III opinion, we noted several factors that impelled us to impose the burden of proof on respondent with respect to whether the misconduct of respondent's attorneys resulted in a fundamental defect or in harmless error. Those same factors apply to the present proceedings concerning the scope and application of the Thompson settlement. As in Dixon III, respondent

has had direct and immediate access to the critical witnesses and most of the relevant documents since May 1992, when the misconduct of respondent's attorneys first came to light. Further, respondent conducted an internal investigation of that misconduct, without the participation of outside parties, soon after discovering the misconduct. Petitioners, on the other hand, have had to rely on discovery and circumstantial evidence, plus whatever evidence respondent has revealed voluntarily. Petitioners have been far less favorably situated than respondent to produce the factual record needed to decide these cases on remand. Furthermore, and finally, as we have previously observed, these cases are not in the normal deficiency posture, and it is the misconduct of respondent's attorneys that is under review. Accordingly, we again conclude that the interests of justice are better served by placing the ultimate burden of proof and persuasion on respondent, and we so hold.[43] See *Rockwell v. Commissioner*, 512 F.2d 882, 885-887 (9th Cir. 1975), affg. T.C. Memo. 1972-133.

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43. Petitioners have filed a motion, as supplemented by a later motion, asking the Court to assign the burden of proof to respondent on 22 specified issues; in so doing, petitioners aver that they do not seek a general allocation of the burden of proof to respondent. Respondent has objected to these motions, quoting *Kluger v. Commissioner*, 83 T.C. 309, 310 n.1 (1984), for the proposition that the Court "has never, in any context, invoked such a sanction". Our action in Dixon III in shifting the general burden of proof and persuasion to respondent in that phase of these proceedings belies respondent's objections. We have concluded that no useful purpose would be served by addressing petitioners' motions on an issue-by-issue basis. Suffice to say we have assigned the burden of proof and persuasion to respondent on each issue of fact that bears on the scope and terms of the Thompson settlement.

We recognize that imposing the burden of proof on respondent may put respondent in the difficult position of having to prove a negative; i.e., that a given outcome or transaction involving the Thompsons was not a result of the Thompson settlement. In other circumstances, when a taxpayer has the burden of proving the negative of a proposition, such as proving the nonreceipt of income, the Court of Appeals for the Ninth Circuit requires the Commissioner to produce at least some substantive evidence linking the taxpayer to the income-producing activity. See *Weimerskirch v. Commissioner*, 596 F.2d 358, 361 (9th Cir. 1979) (respondent must offer "some foundational support" of the receipt of such income), revg. 67 T.C. 672 (1977). Accordingly, in the matter at hand, it is appropriate to require petitioners to produce at least some substantive evidence indicating that asserted benefits to the Thompsons are the result of the Thompson settlement, at least when respondent is in the position of having to prove the contrary. In this regard, it is appropriate for petitioners to rely upon circumstantial evidence, although here, as in other contexts, "'mere suspicion or speculation does not rise to the level of sufficient evidence'". See *United States v. Dinkane*, 17 F.3d 1192, 1196 (9th Cir. 1994) (quoting *United States v. Stauffer*, 922 F.2d 508, 514 (9th Cir. 1990)).

Finally, we believe the factual issues regarding the operative terms and scope of the Thompson settlement, now that the existence and overall significance of the misconduct have been determined, do not present policy considerations that require a heightened standard of proof, such as the requirement of "clear and convincing"

proof of fraud imposed by our Rule 142(b) in deficiency cases, that we applied in Dixon III against respondent in an earlier phase of these proceedings. Accordingly, we hold that the quantum or level of respondent's burden is a "preponderance" of the evidence, the traditional quantum or level of proof required under Rule 142(a) and the case law thereunder.[44] This is the same standard to which we and other courts have, for many years, held taxpayers on questions of general tax liability, and we believe that this is the appropriate standard to apply to respondent in this phase of the proceedings. See Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Am. Pipe & Steel Corp. v. Commissioner*, 243 F.2d 125, 126-127 (9th Cir. 1957), affg. 25 T.C. 351 (1955).

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44. Petitioners have not sought to allocate the burden of proof to respondent on the ultimate question of whether the Thomson settlement is characterized as a 20-percent reduction in deficiencies, plus the payment of the Thompsons' legal fees, or as a 62-percent reduction. See Part C, *infra*. We observe that the significant evidentiary facts on this issue are not in dispute, so that the burden of proof does not enter into what we see as a problem of legal characterization. Therefore, the question does not arise whether we should employ some heightened standard of proof, such as "strong proof" or "clear and convincing" proof, that might otherwise arise when a party to a transaction seeks to disregard the form employed. Our resolution of this issue does not depend on the allocation or standard of the burden of proof.

Appendix B

II. *Defining and Applying the Thompson Settlement*

A. *Overview*

In *Al-Safin v. Circuit City Stores, Inc.*, 394 F.3d at 1258, the Court of Appeals reminded us that its opinion may be consulted to ascertain what was intended by the mandates. In Dixon V, the Court of Appeals described the basis of the "secret settlement agreements" with the Thompsons and the Cravenses as follows: "A condition of their settlements required Thompson and Cravens to remain test case petitioners. * * * With respect to Thompson, McWade agreed to have Thompson's tax deficiencies reduced in proportion to his attorney's fees, which exceeded $60,000." *Dixon v. Commissioner*, 316 F.3d at 1044; fn. ref. omitted. The Court of Appeals further described the Thompson settlement as a "vehicle for paying Thompson's attorney's fees", notwithstanding McWade's testimony that the settlement "was attributable to a separate transaction." *Id.* at 1045.[45]

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45. The reference to a "separate transaction" is to the Thompsons' participation in the Bauspar program. In his brief to the Court of Appeals, Izen explained that McWade and Sims had misled this Court by "denying that the Thompsons [sic] settlement was a vehicle for paying DeCastro's legal fees for representing the Thompsons at the trial of the test cases, [and] by testifying that the Thompsons [sic] settlement was attributable to the Thompsons' participation in the Bauspar program." Additionally, as we observed in Dixon III, "Mr. McWade testified that the Thompsons' settlement was revised in the summer of 1989 in order to dispose of the Bauspar issue. Mr. McWade denied that the Thompsons' settlement was revised to provide a means for the Thompsons to pay Mr. DeCastro's attorney's fees."

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The opinion of the Court of Appeals displays its understanding that the Thompson settlement was a covert transaction, a "secret settlement agreement" that "was a vehicle" to provide the Thompsons with advantages--including payment of attorney's fees through a drastic reduction of deficiencies, and elimination of Kersting and non-Kersting additions--over and above those offered to other taxpayers. Thus, while our sanction should put the other affected taxpayers in the position of having received the benefits the Thompsons received, those benefits should be fairly traceable to the sanctionable conduct of respondent's counsel, McWade and Sims. As we informed the parties in an order dated February 28, 2005:

> The mere fact that the Thompsons received a tax benefit is insufficient to enable the Court to conclude that the benefit was part of the settlement. With respect to each item, it is also necessary to show, or find it appropriate to assume, that respondent's counsel played an enabling or facilitating role in procuring or assuring the benefit to the Thompsons.

B. *Areas of Agreement*

The parties' stipulation of settled issues, in addition to delineating the beneficiaries of the Court of Appeals' mandates, see *supra* Part I.C., establishes some common ground regarding the relief to which those beneficiaries are entitled:

3. The "burnout" element of the Thompson settlement is as follows:

> (a) for taxpayers with 2-3 taxable years before the court, the first year's deficiencies are shifted forward and combined with the deficiencies in the second year then reduced in accord with the Ninth Circuit's mandate; and
>
> (b) for taxpayers with 4 or more taxable years before the court, the first year's deficiencies are shifted forward to the second year and the second year's deficiencies are shifted forward and combined with the deficiencies in the third year, after which all deficiencies are reduced in accord with the Ninth Circuit's mandate.

4. No petitioner will incur any penalties stemming from such petitioners's [sic] Kersting deficiencies.

We incorporate the foregoing stipulations in the relief we announce today.[46]

As for the deficiencies themselves, petitioners and respondent have agreed that the originally determined

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46. We do not adopt all aspects of the parties' stipulation of settled issues. See *infra* note 67.

Kersting deficiencies should be reduced in proportion to the monetary benefit the Thompsons received as a result of the new agreement between McWade and DeCastro. As petitioners explain: "To determine a percentage reduction of aggregate deficiencies requires a numerator and denominator, the numerator being the amount the Thompsons actually paid under the settlement and the denominator being the amount they would have paid absent the settlement."[47] We agree, with the initial caveat that, inasmuch as the parties address both interest and Kersting-related penalties elsewhere, we disregard those items in determining what the Thompsons paid (the numerator) and would have paid (the denominator).

C. *Starting Point: The Thompsons' Settlement of Proposed Deficiencies for 1979-1981*

1. *Respondent's Position*

Respondent's characterization of the Thompsons' settlement of their 1979-1981 deficiencies, as set forth in a status report dated May 28, 2003, has remained constant throughout the proceedings on remand from Dixon V. Respondent maintains, "from a substantive standpoint", that the Thompsons' settlement of their 1979-1981 deficiencies "amounted to a 20% reduction

47. Actually, the resulting percentage would represent the proportion of proposed deficiencies that affected taxpayers would be required to pay. To obtain the "percentage reduction" it will be necessary to subtract the percentage so found from 100 percent.

of the deficiencies"[48] plus "payment of the Thompsons' attorney's fees incurred with respect to the actual trial of the test cases resulting in the opinion in *Dixon v. Commissioner*, T.C. Memo. 1991-614 (Dixon II)." In other words, respondent maintains that the settlement fraction numerator--"the amount the Thompsons actually paid under the settlement"--is $63,000 (the amount of tax the Thompsons remitted to the IRS in June 1987). In respondent's view, the settlement should not reflect the additional $33,000 reduction in tax plus the accompanying interest reductions that generated the refunds of $30,000 in July 1989 and $32,250 in February 1993[49] that were signed over to DeCastro, nor the interest refunds on the resulting overpayments that funded an additional fee payment to Decastro later in 1993 and still left over something that was retained by the Thompsons.

Respondent argues that, because none of the other petitioners (test case or nontest case) incurred attorney's fees for the test case trial (all such fees were paid by Kersting), those petitioners would receive an economic windfall if we were to use the actual 62-percent reduction in the Thompsons' 1979-1981 deficiencies as the starting point for our remedy. Respondent reasons that the 62-percent characterization would provide a benefit to petitioners (the reduction in their proposed deficiencies by an additional 42 percent) that the Thompsons did not enjoy due to their implicit obligation to turn over the

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48. More accurately, 20.55 percent (from $79,294 to $63,000).

49. Respondent applied the remaining $750 to the Thompsons' 1988 tax year.

bulk of the resulting refunds to DeCastro as payment for legal services that conferred no discernible benefit to them. Respondent further argues that the relatively small portion of the refunds of tax and interest ultimately retained by the Thompsons ($17,224.61 out of $98,449.61) is rendered even more insignificant by the fact that the Thompsons reported almost twice that amount ($33,966.68) as gross interest income received from the IRS in 1993 on which they paid tax.[50] In sum, respondent argues, the sweetener embodied in the final settlement that was achieved by increasing the deficiency reduction percentage from 20 percent to 62 percent in effect should be disregarded because the refunds generated thereby purchased nothing of value and provided at most a de minimis increase in the Thompsons' net worth.[51]

2. *Petitioners' Position*

In sharp contrast, petitioners view the Thompsons' settlement of their 1979-1981 deficiencies strictly in terms of the percentage reduction in the total amount of tax

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50. Respondent overlooks the fact that the refunds of $33,966.68 of taxable interest income reported by the Thompsons for 1993 were substantially exceeded by the $51,000 deduction for legal fees claimed by and allowed to them for that year.

51. A more nuanced adoption and application of respondent's argument might arrive at some percentage between 20 percent and 62 percent by increasing the 20 percent to reflect the amount of the refunds actually retained by the Thompsons or the amount they expected or were expected to retain after their endorsement over to DeCastro of the first two refunds. Neither side has advanced such an argument.

the Thompsons were required to pay. Thus, petitioners maintain that the starting point for determining the percentage reduction in deficiencies to which they are entitled is 62.17 percent, representing the final total reduction of the Thompsons' proposed deficiencies for the years at issue from $79,294 to $30,000.

In addition to their argument that the form of the Thompsons' settlement of their 1979-1981 deficiencies (62.17-percent reduction) provides the starting point for determining the appropriate sanction in these cases, petitioners dispute respondent's assertion that the payment of DeCastro's fees was one of the substantive elements of that settlement. Petitioners urge that the evidence does not support a finding that the Thompsons' use of the refunds generated by the final reduction in deficiencies was restricted in any way. They point to some inconsistencies in the estimate of total fees that DeCastro had given to McWade, as well as DeCastro's initial reluctance to acknowledge that respondent had arranged to pay his fees. Accordingly, petitioners argue that the substance of the Thompsons' settlement of their 1979-1981 deficiencies did not depart from the form in which respondent provided it--that is, a reduction of 62.17 percent in the deficiencies originally determined for those years.

3. *Analysis*

As a threshold matter, we do not believe that the inconsistencies perceived by petitioners outweigh the direct and circumstantial evidence that, in substance,

the Thompsons' settlement of their 1979-1981 deficiencies was, in the words of the Court of Appeals, a "vehicle for paying Thompson's attorneys' fees". The preponderance of the evidence shows that, when they made their final deal, McWade and DeCastro intended that the refunds generated by the final reduction of the Thompsons' deficiencies would go to DeCastro in payment of his fees. The fact that the Thompsons endorsed the first two refunds--two checks totaling $62,225--directly to DeCastro's law firm confirms that intention. In a telephone call with Bakutes on June 10, 1992, DeCastro himself conceded that the refunds were intended as a means of paying his fees.

Although we recognize that the payment of DeCastro's fees was an essential element of the Thompsons' settlement of their 1979-1981 deficiencies, it does not follow that respondent's characterization of that settlement (20-percent reduction in deficiencies plus payment of attorney's fees) must prevail. From a practical standpoint, respondent overlooks the fact that the refunds generated by the reduction in deficiencies exceeded the legal fees they were intended to defray. More importantly, inasmuch as the Court of Appeals has taken us to task for twice failing "to equitably resolve" a situation in which respondent's attorneys committed fraud on the court, we believe respondent should be held to the form of the new settlement. That is, we do not think it appropriate to define the Thompsons' settlement of their 1979-1981 deficiencies only by reference to its asserted substance, which would require respondent to reduce the proposed deficiencies of the affected taxpayers by only 20 percent (this would be

the practical effect, because, although respondent would also be required to reimburse the affected taxpayers for attorney's fees, none of the affected taxpayers paid any such fees).[52] We instead think it appropriate to hold respondent to the form of the transaction adopted by his misbehaving attorneys, i.e., the reduction of the Thompsons' 1979-1981 deficiencies by 62.17 percent, without regard to the fact that the Thompsons used the bulk of the refunds generated thereby to pay DeCastro's fees.

We recognize that, in the usual case, it is taxpayers who are held to the form of the transaction they have adopted; once a party has chosen to organize his affairs in a certain fashion, "he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Commissioner v. Natl. Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). On the other hand, respondent generally may disregard the taxpayer's form, and, if that form is "unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins v. Smith*, 308 U.S. 473, 477 (1940). We also recognize that, in these cases, the traditional roles of petitioner and respondent have been reversed. Requiring respondent to assume the procedural posture of a taxpayer does not necessarily

52. The attorney's fees incurred by petitioners for which respondent may be liable relate to further proceedings required by the misconduct of respondent's attorneys and are in no way analogous to the Thompsons' fees to DeCastro for his representation in the original trial in Dixon II.

prohibit respondent from asserting substance over form. We have in mind the following comment of Judge Wisdom: "The taxpayer too has a right to assert the priority of substance--at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction." *Weinert v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961), affg. 31 T.C. 918 (1959).[53]

Our difficulty with respondent's assertion of the "priority of substance" arises from the failure of respondent's actions to show "an honest and consistent respect for the substance of [the] transaction." Here, respondent, through his former attorneys, did not show respect for the substance of the transaction. McWade and Sims tried to hide the settlement from their supervisors, from the other parties, and from the Court. As we have seen, and the Court of Appeals has noted, *Dixon v. Commissioner*, 316 F.3d 1044 n.5, when Thompson was about to reveal his settlement in open court, McWade immediately steered him to another subject. Nor did respondent's attorneys manifest a consistent respect for the substance of the transaction. In substance, the Thompsons' settlement of their 1979-1981 deficiencies was a vehicle for payment of their attorney's fees, but respondent, again through his former attorneys who perpetrated the fraud, characterized it as a refund of taxes to the Thompsons that was solely attributable to Bauspar.

We therefore reject respondent's assertion of substance over form. We shall instead apply to respondent

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53. See Smith, "Substance over Form: A Taxpayer's Right to Assert the Priority of Substance", 44 Tax Law. 137, 142 (1990).

the nondisavowal principle of *Commissioner v. Natl. Alfalfa Dehydrating & Milling Co., supra* at 149, that a party who has chosen to organize his affairs in a certain fashion "must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not." We believe the settlement of the Thompsons' 1979-1981 deficiencies must be applied by giving effect to their receipt of the entire amount of the refunds, rather than by disregarding such receipt as a mere formality in the process of what was, in substance, respondent's manipulation of the tax administrative process to use the Thompsons as a conduit to pay DeCastro's fees.

We are not content to rest our conclusion solely by invoking the nondisavowal principle to hold respondent to the form of the transaction. To do so might give rise to the implication that we have disregarded the substance of the transaction. If we did no more than disregard the substance of the Thompson settlement by upholding its form, respondent might well impeach our conclusion by arguing that we thereby would have disregarded the mandate of the Court of Appeals for the Ninth Circuit to put all petitioners "in the same position as provided in the Thompson settlement".

We therefore push the analysis further by observing that our conclusion accords with principles of Federal income taxation developed by the Supreme Court in analogous situations. Specifically, our treatment of the Thompson settlement is analogous to the treatment of taxpayers who are held to have received gross income,

even though that income was paid directly to a third party. Petitioners cite *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), in which the Supreme Court held that an employer's payment of its employees' income taxes should be recognized as a taxable payment of additional compensation to the employee.[54]

Our conclusion is supported by the recent decision of the Supreme Court in *Commissioner v. Banks*, 543 U.S. 426 (2005). There, Mr. Banks settled an employment discrimination suit for $464,000 and, pursuant to a contingent fee arrangement, paid his attorneys $150,000 of that amount. The Supreme Court held that the $150,000 fee amount was includable in the gross income of Mr. Banks, notwithstanding his preexisting obligation to pay approximately one-third of his total recovery to his lawyers.[55] We read the Supreme Court's opinion in *Banks*

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54. We note that the Thompsons did not report as gross income the first refund of $30,000, presumably because it was a refund of tax they had previously paid. Moreover, they did not claim that amount as a deduction under sec. 212(3) when they endorsed the check for that amount to DeCastro, as a partial payment on account of his legal fees. Although their failure to claim the deduction operated as a tax detriment to the Thompsons, there is no evidence that their forbearance was in any way related to the deal with McWade.

55. We note that in *Kenseth v. Commissioner*, 114 T.C. 399 (2000), affd. 259 F.3d 881 (7th Cir. 2001), a majority of this Court upheld respondent's contention that the taxpayers were chargeable with the receipt of gross income on the portion of a settlement that was used to pay their attorney under a contingent fee arrangement. In *Kenseth*, the taxable year was 1993, the taxable

as confirming and applying the general principle that the portion of a settlement that is dedicated to the payment of the plaintiff's attorney's contingent fee is still regarded as received by the plaintiff even though he is not expected or entitled to retain it.

Our conclusion is guided also by the fact that the Court of Appeals has specifically directed us to provide the equivalent of the Thompson settlement as a sanction against respondent. We do not believe that the Court of Appeals contemplated the application of this aspect of the Thompson settlement in the way that respondent urges, that is, as a 20-percent reduction in proposed deficiencies, together with the hollow requirement that respondent reimburse the many other affected petitioners for attorney's fees that in fact they never incurred. If we did so, we would not be applying the equivalent of the Thompsons' 1979-1981 settlement; instead we would be applying essentially the same 20-percent reduction settlement that McWade extended to other taxpayers, including other clients of Chicoine and Hallett and DeCastro, the monetary benefit of which respondent would

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year for which, in the matter at hand, respondent contends that we should disregard as a formality the Thompsons' receipt of the second refund they used to pay their attorney.

We observe that our hewing to the form of the transaction as generating refunds of tax and interest to the Thompsons obviates any argument by petitioners that the Thompsons received a tax benefit in not being required to report as gross income the receipt of the refund of tax that enabled them to make their first installment payment of DeCastro's attorney's fees.

have been content to allow the Thompsons to retain. We believe the modest deficiency reduction percentage urged by respondent would not provide an appropriate sanction for misconduct that the Court of Appeals has held to be a fraud on this Court. To adopt respondent's view would be to ignore the financial terms and effects of the final settlement that was sweetened for the illicit purpose of creating the fund from which DeCastro's trial fees could be paid.

We conclude that the Court of Appeals intended that the Thompsons' "secret agreement" with respect to 1979-1981, to the extent it reflected the reduction of deficiencies to $30,000 for those years, is to be applied as a reduction of 62.17 percent in the Kersting deficiencies of the affected taxpayers, rather than the 20-percent reduction urged by respondent, or some intermediate percentage based upon the actual or expected amounts of the refunds to be retained by the Thompsons after payment of DeCastro's fees. See *supra* note 51. In terms of the "settlement fraction" discussed above, we begin with a numerator of $30,000 (the total 1979-1981 tax deficiency the Thompsons paid) and a denominator of $79,294 (the 1979-1981 tax deficiencies the Thompsons would have paid absent the settlement).

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D. *Other Benefits Relating to the Thompsons' 1981 Tax Year*

1. *Elimination of the Thompsons' Late Filing (Non-Kersting) Addition for 1981*

Petitioners maintain that the denominator of the settlement fraction should be increased by $4,934.32, representing the late filing addition in the Thompsons' statutory notice for 1981 that they would have had to pay absent the settlement of their 1979-1981 tax years. We disagree. Respondent's proposed application of non-Kersting penalties and additions was specific to individual taxpayers, unlike the Kersting-related deficiencies and additions for which all affected taxpayers are liable. For that reason, we believe it is appropriate to limit the benefit of this aspect of the Thompson settlement (relief from liability for non-Kersting additions) to those affected taxpayers who, like the Thompsons, were subject to non-Kersting additions. We therefore deal with this aspect of the Thompson settlement separately from our determination of the percentage reduction in Kersting deficiencies that will apply to all affected taxpayers. See *infra* Part II.G.1.

2. *Respondent's Failure To Address the Bauspar Issue in the Thompsons' Statutory Notice for 1981*

As discussed above, the Thompsons began participating in the Bauspar program in 1981. Respondent's notice of deficiency with respect to the Thompsons' 1981 tax year

did not disallow the $8,000 claimed by the Thompsons on their 1981 return as home mortgage interest, interest that was probably attributable to the Bauspar program. By August 1985, when the Thompsons filed their petition in this Court for 1981, respondent was generally precluded from revising the statutory notice to include the Bauspar issue. See sec. 6212(c)(1). Because that cutoff date predates the Thompsons' retention of DeCastro by more than a year, respondent's failure to include the Bauspar issue in the statutory notice for 1981 could not have been part of the secret settlement agreement between DeCastro and McWade.[56]

E. *Benefits to the Thompsons Relating to Years Other Than 1979-1981*

1. *In General*

Respondent maintains that the only years covered by the Thompson settlement were the Thompsons' 1979-1981 taxable years before the Court in this proceeding. Petitioners, on the other hand, maintain that the Thompson settlement covered a number of years between 1979 and 1993, thereby increasing the percentage reduction in Kersting deficiencies to which they are entitled to 79.95

56. Respondent presumably could have raised the Bauspar issue later by seeking leave to amend his answer in the Thompsons' 1981 Tax Court case. See sec. 6214(a); Rule 41(a); Rule 142(a) (shifting the burden of proof to the Commissioner with respect to the increased deficiency). For reasons discussed *infra* in Part II.E.4., we need not concern ourselves with that possibility.

percent.[57] They base this percentage on their calculation that, absent the settlement, the amount of taxes the Thompsons would have paid respondent for the taxable years 1979-1983, 1986-87, and 1993 was $143,894.10, while the amount they actually paid was $28,894.87 ($30,000 reduced by $1,105.13 that respondent maintains Mr. Thompson improperly received as reimbursement for his travel to Hawaii to testify in the Dixon II trial). We examine various suspect benefits below.[58]

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57. In a separate brief, petitioners' counsel Sticht argues for a "cashflow" approach to the calculation of the reduction percentage, which would bring the initial reduction percentage to 86.8 percent of petitioners' aggregate deficiencies, additions, and interest. Without closely following the mechanics of Sticht's calculation, we reject the cashflow approach out of hand. It completely disregards the time value of money principles that underlie our Preliminary Comments. See text accompanying notes 38, 39, and 40, *supra*.

We also note that, in the course of the evidentiary hearing required by the Dixon V mandates, petitioners' counsel O'Donnell and Jones filed motions for summary judgment of "100-percent discount" as a sanction. We denied the motions and the motions for reconsideration of our denials because of numerous outstanding issues of material fact. With the completion of the evidentiary hearing and issuance of our opinion herein, we now regard petitioners' motions to characterize the Thompson settlement as a 100-percent reduction in the Kersting-related deficiencies as having been denied on the merits.

58. We note that petitioners do not question the settlement of the Thompsons' 1978 tax year, which was apparently the first year for which the Thompsons claimed Kersting deductions. In any event, that settlement was consummated in early to mid-1986, before DeCastro came on the scene.

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2. *The Thompsons' Escape From Kersting Liability with Respect to 1982*

As discussed earlier, the Thompsons claimed Kersting (and probably Bauspar) deductions on their 1982 return sufficient to reduce their adjusted gross income of $99,364 to $4,336. Respondent took no action with respect to that return, and the generally applicable 3-year period of limitations for the Thompsons' 1982 tax year expired in May 1986. Given the fact that the Thompsons did not retain DeCastro until November 1986, respondent's failure to act on the Thompsons' 1982 return before the expiration of the 3-year period of limitations could not have been part of the secret settlement agreement between DeCastro and McWade.

Petitioners nevertheless maintain that the Thompsons' escape from Kersting liability with respect to 1982 is attributable to the DeCastro/McWade agreement. In support of that argument, they point to DeCastro's August 3, 1989 letter to McWade, which states: "We have agreed that the total taxes due *for all the open years* are $15,000 for 1980 and $15,000 for 1981." (Emphasis added.) Petitioners then argue that the Thompsons' 1982 tax year was still fair game at that time because Mr. Thompson's fraud rendered the statute of limitations inapplicable pursuant to section 6501(c)(1). They argue that Mr. Thompson was liable for fraud because he had claimed Kersting deductions even though he believed he wouldn't have to pay the notes.

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Petitioners' arguments are farfetched. Allegations of fraud are serious business. The grounds for asserting civil fraud were succinctly explained in *Webb v. Commissioner*, 394 F.2d 366, 377 (5th Cir. 1968) (quoting *Carter v. Campbell*, 264 F.2d 930, 935-936 (5th Cir. 1959)), affg. T.C. Memo. 1966-81:

> "Fraud implies bad faith, intentional wrongdoing and a sinister motive. It is never imputed or presumed and the court should not sustain findings of fraud upon circumstances which at most create only suspicion. * * * Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. Mere negligence does not establish either. * * * "

We amplified these requirements in *Fields v. Commissioner*, T.C. Memo. 2002-320:

> To succeed in the instant case, respondent must show that he had a reasonable basis for believing that he could prove his allegation of petitioner's fraud by clear and convincing evidence. See, e.g., *Rutana v. Commissioner*, 88 T.C. 1329, 1337-1338 (1987). More particularly, he must show that he had a reasonable basis for believing that he could prove by clear and convincing evidence that petitioner willfully intended to evade a tax she believed to be owing.

In *Fields*, where we found that respondent lacked a reasonable basis for asserting fraud, we awarded attorney's fees to the petitioner under section 7430. See also *Benson v. Commissioner*, T.C. Memo. 2004-272.

When DeCastro wrote to McWade confirming their deal, respondent had not asserted fraud for any of the Thompsons' taxable years that were before the Court, in all three of which the Thompsons had claimed substantial Kersting-related deductions. Respondent, in fact, has not asserted fraud charges against any of the test case or nontest case petitioners with respect to Kersting deficiencies. Nor, for that matter, did respondent even assert fraud charges against Kersting himself, when respondent issued a deficiency notice to Kersting for his failure to report more than $11 million of fee income he received over a 7-year period (1982-88) from the Kersting project petitioners through his alter ego corporations. See *Kersting v. Commissioner*, T.C. Memo. 1999-197.

Nor do we believe the facts of the Thompsons' case would support an assertion--much less a finding--of fraud against Mr. Thompson. Petitioners point to Mr. Thompson's trial testimony, in which he "admitted that he had taken Kersting deductions while believing the debt to which the deductions related would not have to be repaid." We believe this testimony is true and consistent with our findings in Dixon II and Dixon III regarding the Kersting shelters. We further believe this testimony falls far short of demonstrating, by clear and convincing evidence, that, by claiming the Kersting deductions, Mr. Thompson specifically intended to evade a tax known to be owing. Our skepticism is based upon our perception that charging

Mr. Thompson with fraud in these circumstances would attribute to Mr. Thompson substantially more knowledge of tax law than he ever had. When his 1982 tax return was filed, Mr. Thompson was a retired airline pilot, who, like more than 1,000 of his colleagues duped by Kersting, unwisely bought into a spurious tax shelter. Petitioners apparently would have us accept the proposition that Mr. Thompson was familiar with the laws governing the deduction of interest payments where there is some question whether the taxpayer involved is personally at risk.

This Court had substantial opportunity to evaluate the credibility of Mr. Thompson, who testified for 2 days during the evidentiary hearing mandated by *DuFresne*. We found no basis for suspecting him of fraud; to the contrary, if he had engaged in fraud, we doubt he would have admitted that he didn't think he was personally at risk on the Kersting notes. Instead, we concluded that his testimony at the test case trial "was truthful."

More to the point, we believe Mr. Thompson's true beliefs are those shown by his letter to McWade dated November 6, 1989. In this letter, Mr. Thompson expressed his anger and confusion at the part he had been made to play by the machinations of DeCastro and McWade:

> I received a check from IRS in the amount of thirty thousand dollars--($30,000). I endorsed this over to DeCastro Law Corp; this did not retire the billed amount. I am completely amazed at the billings we are receiving. I

> am now in receipt of additional billings that exceed realistic amounts. In fact the total comes to sixty six thousand two hundred forty three and 66/100 dollars ($66,243.66). At some point I know a reconciliation will come. Luis [DeCastro] says don't be concerned. I am very concerned, I am the one being billed.
>
> * * * * * * *
>
> Most emphatically I did not expect to be a channel through which IRS funneled funds to any law firm. Certainly not in this magnitude. I have the feeling at this point that I am correct in this--the bill is to [sic] much. I want to know the exact legal position I occupy. We have been frustrated long enough. We wish to close this chapter.

Mr. Thompson's reaction as displayed by this letter is not that of a willing participant in a fraudulent conspiracy; instead, it's the outrage of a mark who finally realizes he's been a tool in somebody else's game.

The two cases cited by petitioners reinforce our conclusion. In *Popkin v. Commissioner*, T.C. Memo. 1988-459, affd. without published opinion 899 F.2d 21 (11th Cir. 1988), and *Fried v. Commissioner*, T.C. Memo. 1989-430, affd. 954 F.2d 730 (11th Cir. 1992), the Commissioner determined fraud penalties against tax shelter promoters who themselves had invested in four types of tax shelters, involving books, movies, lithographs, and coal mining. This

Court rejected the Commissioner's fraud determinations in the book, movie, and lithograph shelters. The Court did, however, sustain the fraud penalties against the promoters for their participation in the coal-mining shelters. These conclusions were based upon their complicity in backdating documents and failing to deliver promissory notes. Here, in contrast, there is no evidence of Mr. Thompson's engaging in any backdating, failure to make delivery, or any other dishonesty "upon which, in large part" we relied in finding fraud in *Popkin* and *Fried.*

In sum, there is not now, nor was there ever before, any basis to assert fraud against Mr. Thompson for 1982. Accordingly, the period of limitations for that year expired in May 1986. That being the case, the Thompsons' 1982 tax year was not an open year to which DeCastro's August 3, 1989, letter to McWade could have applied. We find and hold that the Thompsons' 1982 taxable year was not affected by, and was not part of, the Thompson settlement.[59]

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59. In all likelihood, the Thompsons' 1982 tax year simply slipped through the cracks as a result of the haphazard operation of the audit lottery. The record in these cases reveals numerous other instances in which respondent failed to catch all the taxable years of all the Kersting deductions claimed by participants in Kersting's shelters. For example, test case petitioners Richard and Fiorella Hongsermeier escaped audit for their 1981 and 1982 taxable years, and respondent acknowledges that the IRS "missed" the 1984 through 1986 taxable years of other Kersting petitioners.

Appendix B

3. *The Thompsons' 1983 Kersting Deficiency and the Disappearing Statutory Notice*

Concerning the year 1983, matters are substantially different. Unlike 1982, the Thompsons' 1983 tax return did not slip through the cracks. Instead, respondent's Fresno Service Center had prepared a statutory notice of deficiency dated March 17, 1987, disallowing Kersting deductions and asserting a deficiency of $980. The statutory notice appears to have been issued; notations in respondent's administrative records indicate that respondent received an inquiry regarding that notice in May 1987. Nonetheless, no petition on behalf of the Thompsons was filed in this Court regarding the deficiencies proposed for 1983. Nor, moreover, did respondent assess or collect the deficiency determined in the statutory notice. Instead, for reasons not explained, respondent's determination for 1983 was ignored, and the year was allowed to lapse.

Early in 1987, when the Thompson statutory notice of deficiency for 1983 was being prepared, McWade and DeCastro were actively involved in resolving the Thompsons' tax matters pursuant to their original settlement. In March 1987, McWade provided a sweetener of the original settlement that slightly reduced the determined deficiencies for the years before the Court to bring the reduction up to 20.55 percent. Additionally, during the prior December and January, he had helped process the Thompsons' interest payments for 1986.

If there were an explanation for the apparent abandonment of assessment and collection procedures

well under way for the Thompsons' 1983 taxable year, we would expect respondent to be able to provide one, but he has not. Therefore, under the burden of proof approach we have adopted, we hold that the Thompsons' escape from a $980 deficiency for 1983 was part of the Thompson settlement, and that this amount should be included in the denominator for determining the percentage reduction in Kersting deficiencies to be afforded all affected taxpayers before the Court.[60]

4. *The Thompsons' 1983-85 Bauspar Deductions*

The Thompsons, like some other Kersting project participants, apparently deducted substantial amounts as home mortgage interest on their 1983-85 returns, on the basis of payments under the Bauspar program that may not have met the requirements for deductible home mortgage interest. While respondent concedes that the Thompsons probably derived a benefit from overstated Bauspar interest deductions for those years, the precise amount of that benefit is not readily ascertainable because the payees of claimed mortgage interest are not identified on the returns.

Although the Thompsons were audited by the IRS for each of the 1983-85 years, no deficiencies were ever

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60. The last year for which the Thompsons claimed Kersting deductions was 1984. As discussed earlier, Revenue Agent Speers ultimately disallowed the Thompsons' Kersting deductions for that year ($7,740) in full, and the Thompsons paid the resulting deficiency of $1,830.

determined against them with respect to the Bauspar program, even though, as respondent's counsel O'Neill reported: "There are some other docketed cases where we have disallowed mortgage interest." We believe that escaping Bauspar deficiencies was an implied term of the Thompson settlement; while Sims and McWade knew that the Thompsons had participated in the Bauspar program, the settlement that they engineered assured that no Bauspar deficiencies were determined, assessed, or collected from the Thompsons. Thus, in the absence of circumstances indicating that the Thompsons' escape from Bauspar-related deficiencies was not engineered by Sims or McWade, we conclude that Bauspar relief was part of the Thompson settlement.[61]

Because the amounts of the Thompsons' Bauspar deductions are incapable of determination with any precision, and because respondent disallowed Bauspar deductions only sporadically for a small number of taxpayers, we deal with this aspect of the Thompson settlement separately from our determination of the percentage reduction in Kersting deficiencies that will apply to all affected taxpayers. See *infra* Part II.G.2.

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61. In so holding, we do not retract our conclusion in Dixon III that McWade and Sims lied in testifying that the final Thompson settlement had the purpose and effect of giving the Thompsons refunds by way of carrybacks of amounts they had lost by reason of their participation in Bauspar.

Appendix B

5. *The Thompsons' Deduction of Prepaid Interest on Their 1986 and 1987 Returns*

1986

The Thompsons paid $25,545 of deficiency interest on December 30, 1986.[62] Because the Thompsons' adjusted gross income for 1986 was relatively low, they ultimately were able to use only $16,251 of deficiency interest as a deduction on their 1986 return. Petitioners maintain that respondent should have disallowed that deduction in its entirety because the Thompsons did not pay the corresponding amount of the proposed deficiencies in 1986.

Petitioners' argument requires us to examine the state of the tax law as of December 30, 1986. At that time, interest on Federal income tax deficiencies was treated as "personal interest", which was fully deductible by the taxpayer making the payment. See *Robinson v. Commissioner*, 119 T.C. 44, 54 (2002). During 1986, however, the Internal Revenue Code was amended, prospectively, to add a new section 163(h), which repealed the deduction for personal interest. See TRA, Pub. L. 99-514, sec. 511(b), 100 Stat. 2246. Under the provision, 1986 was the last taxable year in which taxpayers could deduct 100 percent of such personal interest. TRA sec. 511(e),

62. Although the Thompsons purported to pay $59,545 of deficiency interest on that date (and reported that amount as deficiency interest expense on Schedule A, Itemized Deductions, of their 1986 return), the larger of the two checks issued for that purpose (in the amount of $34,000) was dishonored, and the Thompsons did not send a replacement check until February 1987.

100 Stat. 2246. For the next year, 1987, only 65 percent of personal interest was deductible, and the deduction for personal interest was phased out entirely by the end of 1989. Sec. 163(h)(6).

In a news release issued October 23, 1986, the IRS advised: "Since under the Tax Reform Act of 1986 interest on most tax deficiencies of individual taxpayers will not be fully deductible after 1986, taxpayers may wish to pay actual or contested deficiencies now to obtain the full interest deduction on 1986 tax returns." The news release accordingly included, as an attachment, Announcement 86-108 (Ann. 86-108), 1986-45 I.R.B. 20, which provided guidance to taxpayers wishing to obtain the full deductibility of deficiency interest in 1986.

Under paragraph 4, "General Considerations", Ann. 86-108 states: "In general, a taxpayer may not pay interest on a contested deficiency without simultaneously paying, or agreeing to pay, the underlying tax deficiency with respect to which the interest is being paid." The "Detailed Instructions" of Ann. 86-108 describe two situations that arguably apply here. Respondent argues that the Thompsons' situation was governed by section C.1.b. ("Taxpayers Desiring to Settle Their Tax Court Cases"). Under this provision a taxpayer whose case is pending before this Court and who "wishes to settle the case on some other basis than a full concession" is directed to contact respondent's attorney or Appeals officer to whom the case is assigned. Then, "If a settlement is agreed to, the attorney or Appeals Officer will prepare the appropriate decision document." *Id.*

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In this case, when they prepaid their interest, the Thompsons (through DeCastro) had actually reached a settlement of their liabilities for 1979-1981 with McWade. McWade prepared the appropriate decision documents, and he and DeCastro both signed those documents, which reflected the settlement and contained an express waiver of the restrictions against assessment and collection of the liabilities. Accordingly, as of December 31, 1986, the Thompsons had agreed to pay approximately 80 percent of the deficiencies originally determined against them, and their attorney had, in fact, executed decision documents to that effect. Under section C.1.b of Ann. 86-108, the Thompsons' agreement appears to have qualified their payment of deficiency interest for full deductibility.

Petitioners argue that another provision of Ann. 86-108 applies. Section C.1.c. addresses "Taxpayers Desiring to Make a Payment in 1986, While Continuing to Contest the Asserted Deficiency in Tax Court". That provision directs that, in order to obtain an interest deduction for payment made in 1986 while continuing to litigate before the Tax Court, the taxpayer must simultaneously pay the amount of the contested tax deficiency to which the interest being paid is attributable. Petitioners note that the agreement between DeCastro and McWade permitted the Thompsons to receive the better of their settlement agreement or the result of the Tax Court proceedings. Accordingly, petitioners argue, the Thompsons were, in effect, continuing to contest the determined deficiencies in this Court within the scope of Ann. 86-108, sec. C.1.c. Petitioners therefore maintain that because the Thompsons prepaid only the interest and none of the contested tax

deficiencies, the Thompsons were not entitled, under Ann. 86-108 section C.1.c., to deduct the interest.

In *Perkins v. Commissioner*, 92 T.C. 749 (1989), a reviewed opinion with no dissents, this Court held that a payment designated as accrued interest made after a notice of deficiency has been issued is deductible in the year paid, even though the underlying tax has not been paid. See also *Preble v. Commissioner*, T.C. Memo. 1989-208. We based our holding on two provisions of the Internal Revenue Code: Section 163(a), which permits a deduction of interest without requiring that the underlying obligation be paid, and section 461(f), which permits a deduction of interest in the year in which it is paid, even though the taxpayer's liability for the underlying debt is contested. We concluded that the revenue procedure upon which section C.1.c. of Ann. 86-108 is based had imposed "an unwarranted restriction" by requiring payment of the obligation. *Perkins v. Commissioner*, *supra* at 760.

Petitioners argue that we rejected respondent's restrictions on the deductibility of interest on contested deficiencies well after the Thompsons had deducted such interest. At that time, they argue, section C.1.c. of Ann. 86-108 operated to deny the claimed deduction. Petitioners' argument, in sum, is that respondent should have disallowed the Thompsons' 1986 interest deduction under an incorrect legal theory. Petitioners essentially ask that we include in the denominator of the settlement fraction a tax benefit to which the Thompsons were already entitled under a correct application of the law. We decline to do so, regardless of whether McWade played any part in respondent's allowance of the deduction.

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1987

The Thompsons reported deficiency interest expense of $42,945 on Schedule A of their 1987 return and deducted 65 percent of that amount ($27,914). See *supra* note 14. The claimed deduction appears to derive from Poltash's misguided attempt to carry over the unused portion of the $59,545 of deficiency interest expense reported on Schedule A of the Thompsons' 1986 return. See *supra* note 15. Such a deduction was improper; the Internal Revenue Code did not and does not permit the carryover of an individual cash-basis taxpayer's unused personal interest deduction from one year to the next.

The Thompsons did, however, make a valid payment of interest early in 1987, when they issued a valid check for $34,340 to replace the dishonored check they had mailed the previous year (the extra $340 was a bad check charge). As cash-basis taxpayers, and under the law applicable for 1987, they would have been permitted to deduct 65 percent of that amount, or $22,100, as personal interest. This valid deduction would have been $5,814 less than the $27,914 actually claimed and used as an interest deduction on their 1987 return. If the $5,814 excess amount deducted were added back to their taxable income for 1987, the Thompsons' tax liability would have been increased by $1,624.

Accordingly, we conclude that for their taxable year 1987 the Thompsons received a modest tax benefit during the time McWade and DeCastro were colluding to reduce the Thompsons' tax liabilities. There is no evidence

that McWade directly intervened to cause this excess deduction, but there is evidence that he took an active role in seeing that the prepaid interest was posted in time to permit full deduction in 1986. We conclude that the excess deduction of personal interest in 1987 is improper and not one that would have been extended to other affected taxpayers. Thus, while it is unclear that McWade undertook any action to secure the improper deduction, it is also unclear that he did not, and he had the access and ability to do so. In accordance with the burden of proof we have imposed upon respondent, and in the absence of circumstances showing that the Thompsons' excess interest deduction for 1987 was not engineered with the collusion of respondent's counsel, we find that this benefit was part of the Thompson settlement. We shall add the $1,624 tax benefit to the denominator of the fraction that will determine the percentage reduction in Kersting deficiencies to be afforded all affected taxpayers.

6. *The Thompsons' Attorney's Fee Deduction for 1993*

On their 1993 tax return, the Thompsons deducted the additional $51,000 of legal fees paid in that year to DeCastro. Petitioners maintain that the deduction of legal fees paid to DeCastro was improper, and that the amounts so deducted should be included in the Thompson settlement. We disagree.

Section 212(3) allows the deduction of legal fees paid or incurred "in connection with the determination, collection, or refund of any tax." Regulations further provide that

"expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible." Sec. 1.212-1(l), Income Tax Regs.

DeCastro obviously represented the Thompsons in "proceedings involved in determining the extent of tax liability or in contesting * * * tax liability." The Thompsons hired him to resolve their tax problems. He did so, not only by negotiating the settlements with McWade but also by appearing on behalf of the Thompsons at the trial of the test cases in 1989. Additionally, after respondent had discovered and disclosed the misconduct of respondent's counsel, DeCastro successfully enforced the terms of the new settlement, over respondent's objections, in the Tax Court. The Thompsons' payments to DeCastro clearly satisfy the definition of deductible legal fees.

Petitioners complain that, in view of DeCastro's fraudulent deal with McWade, DeCastro's legal fees fail to meet the statutory requirement that they be "ordinary and necessary" expenses of the Thompsons. Petitioners' complaint ignores the Supreme Court's holding in *Commissioner v. Tellier*, 383 U.S. 687 (1966), that legal fees otherwise qualifying as ordinary and necessary expenses are deductible without regard to public policy objections. Although DeCastro appears to have participated in the fraud on the court, his fees remain deductible for tax purposes; the basic proposition is that "the federal income tax is a tax on net income, not

a sanction against wrongdoing." *Id.* at 691. Moreover, "With respect to deductions, the basic rule, with only a few limited and well-defined exceptions, is the same."[63] *Id.* We conclude that the Thompsons' payments of DeCastro's legal fees generated allowable deductions that were not a part of the improper tax benefits provided by the Thompson settlement.

7. *The Thompsons' Failure To Report Tax Benefit Income for 1993*

While we agree with respondent that the Thompsons were entitled to deduct the attorney's fees paid to DeCastro in 1993, we agree with petitioners that the Thompsons' 1993 return is incorrect in a different respect: it does not reflect the Thompsons' realization of income under the tax benefit rule. Recall that the Thompsons deducted $44,165 of deficiency interest expense for 1986-1987 ($16,251 for 1986 and $27,914 for 1987) as a result of their interest prepayments for the deficiency years 1979-1981. This Court's order and decision of August 26, 1992, which held respondent to the terms of the Thompson settlement, resulted in the Thompsons' ultimately paying only $27,506 in interest for those years.

This situation should have resulted in application of the tax benefit rule. The tax benefit rule is a judicially created principle that serves to remedy certain disparities

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63. The statutory exceptions, none of which applies here, are contained in sec. 162(c), (f), and (g). See sec. 1.212-1(p), Income Tax Regs.

inherent in the use of an annual accounting system for the reporting of Federal income taxes. *Hillsboro Natl. Bank v. Commissioner*, 460 U.S. 370, 377 (1983). The tax benefit rule rectifies the inequity that results when a deduction is taken during one taxable year and later events show that the deduction would not have been allowable if all relevant facts had been known at the time of the deduction. *Id.* at 383-384. In operation, the tax benefit rule requires the taxpayer to recognize the amount so deducted as income in the year of the later, inconsistent event. The amount the taxpayer must include in income, however, is limited to the amount of the deduction that provided a tax benefit for the prior year. E.g., *Rojas v. Commissioner*, 90 T.C. 1090, 1097 (1988), affd. 901 F.2d 810 (9th Cir. 1990). In the case at hand, the excess of the $44,165 deducted over the $27,506 actually paid as interest is $16,659. The inconsistent event occurred in January 1993, when respondent assessed only $27,506 of interest with respect to the Thompsons' 1980 and 1981 tax years on the basis of the decisions entered by the Tax Court in August 1992. Respondent in effect refunded the excess $16,659 to the Thompsons by applying it as a credit toward their $15,000 deficiencies for each of 1980 and 1981. The Thompsons thus had a "tax benefit" of $16,659 in 1993 that they failed to report on their return for that year.

Although the Thompsons' failure to include income under the tax benefit rule was erroneous, it did not result from the intervention of respondent's attorneys. To the contrary, by the time the Thompsons filed their 1993 income tax return, many attorneys in respondent's Office of Chief Counsel, at the local, regional, and national

levels, were seeking to control the damage caused by McWade's preferential treatment of the Thompsons for the years 1979-1981. The misconduct was also before the Court of Appeals in the *DuFresne* appeal. McWade had retired from the IRS, and Sims had been disciplined by respondent's Regional Counsel. Responsibility for the Kersting project cases had been transferred to Dombrowski and O'Neill. The sources of the misconduct in the handling of the Thompsons' tax matters had been effectively removed.

Dombrowski, who was assigned McWade's duties with respect to the test cases, did not engage in or perpetuate any misconduct. He instead found himself faced with DeCastro's apparently valid request for a refund of interest accruing on the payments the Thompsons had paid for their 1979-1981 taxable years. Dombrowski approved that refund only after obtaining the approval of his superior in the Regional Office and only after having some of respondent's experienced employees doublecheck his figures.

During his testimony, Dombrowski did not recall whether he had told DeCastro about the income tax ramifications of the refund under the tax benefit rule, but it was not his duty to do so. Dombrowski's approval of a refund of interest and deficiencies was a result of his assignment to take over McWade's duties for the Thompsons' taxable years 1979-1981 that were before the Court and that had been affected by the misconduct of McWade and Sims. There is no basis for finding that Dombrowski had an affirmative obligation to demand, or

intervene in, any audit of the Thompsons' 1993 return as subsequently filed in 1994. To the contrary, any errors of omission or commission in failing to report the Thompsons' tax benefit income were the responsibility of Poltash, their tax accountant, and DeCastro, their tax attorney. We therefore conclude that respondent's failure to ensure that the Thompsons reported tax benefit income on their 1993 return (and respondent's subsequent failure to adjust the return accordingly) was not part of the Thompson settlement.

8. *Payment of Witness Fees to Mr. Thompson*

Petitioners urge that the Thompson settlement includes respondent's payment of witness fees and mileage to Mr. Thompson, who testified in January 1989 at the trial before Judge Goffe in response to a subpoena issued by respondent. We have noted that respondent subpoenaed all the test case petitioners and also paid Mr. Cravens's witness fees. We have also noted that there is no record evidence regarding any requests for reimbursement of witness fees on behalf of any other test case petitioner.[64] Such requests would have been required in order to obtain reimbursement, inasmuch as Rule 148(b) in effect provides that the Commissioner, unlike a private party, is

64. Rule 148(a) states: "Any witness summoned to a hearing or trial, or whose deposition is taken, shall receive the same fees and mileage as witnesses in the United States District Courts." Rule 148(b) refers to sec. 7457(b)(1), which provides in turn: "In the case of witnesses for the Secretary, such payments [of fees, mileage and expenses] shall be made by the Secretary out of any moneys appropriated for the collection of internal revenue taxes".

not required to tender fees and mileage in order to issue a valid subpoena.

On the basis of this record, we do not believe respondent's payment of Thompson's witness fees and expenses was a benefit that was unavailable to the other petitioners who testified at the trial of the test cases. Accordingly, we conclude that such payment was not part of the Thompson settlement. Having so concluded, there is no need to reach petitioners' argument that the payment of Thompson's fees was a benefit that should be given effect by subtracting it from the numerator of the settlement fraction rather than adding it to the denominator.

9. *Release of Lien on the Thompsons' Property and Other Intangible Benefits*

On February 8, 1982, respondent had filed a notice of Federal tax lien for the unpaid balance due of $23,385.78 for the Thompsons' taxable year 1978, which did not involve the disallowance of any Kersting deductions. As detailed in respondent's records, the Thompsons made a number of payments on the liability, which was finally satisfied in September 1987. Under section 6325(a)(1), the IRS was required to issue a certificate of release of lien within 30 days (in this case, by October 7, 1987). This was not done in a timely fashion. The lien was released, however, following a meeting between DeCastro and McWade in Hawaii late in 1988 at the time of Kersting's deposition. Again, although this relief may have been brought about by McWade's efforts, it was not a tax advantage that would not have been available to other similarly situated taxpayers.

The Thompsons were entitled to have the lien released by operation of section 6325(a). We believe that an inquiry by any other taxpayer's representative would have produced the same relief. We conclude that the release of the lien was not a part of the Thompson settlement.

Petitioners argue that the Thompsons received other "intangible benefits", including not only "assistance with getting the tax lien released from their house", but also "use of the test-case trial as a platform for defending against Henry Kersting, and avoiding the collection, litigation, disillusion and anxiety that have been experienced by the other taxpayers." They concede that, in terms of imposing sanctions, "it does not seem possible to confer those benefits on other taxpayers." They urge, however, that such benefits be deemed "ballast" in weighing the sanctions to be imposed.

We believe that, in responding as we have to the mandates of the Court of Appeals, we have accounted for the problems faced by the other affected taxpayers. We are painfully aware, as the Court of Appeals for the Ninth Circuit has observed, that "Enormous amounts of time and judicial resources have been wasted" and further that the "taxpayers should not be forced to endure another trial". *Dixon v. Commissioner*, 316 F.3d at 1047. We further recognize the urgent need to "equitably resolve this situation" to the best of our abilities. *Id.* Despite our rejection of any notion of "ballast" as an impermissible invitation to fix damages against respondent, we are confident that our implementation of the mandates, in conjunction with respondent's concession cutting short

the accrual of interest on deficiencies, see *infra* Part III, will provide substantial relief to all affected taxpayers.

F. *The Percentage Reduction Summarized*

To summarize our holdings above, we shall direct that the Kersting-related deficiencies[65] for each of the affected taxpayers are to be reduced by a factor of 63.37 percent; that is, affected taxpayers will have to pay 36.63 percent of the amounts of tax they would have had to pay. We have calculated the reduction percentage as follows:

The numerator is $30,000, representing the total deficiencies paid by the Thompsons for the taxable years before the Court, that is, their taxable years 1979-1981.

The denominator is initially $79,294, representing the total deficiencies that respondent asserted against the Thompsons for their 1979-1981 taxable years. To this sum we add $980, representing the deficiency the Thompsons escaped paying for the year 1983 by virtue of respondent's unexplained failure to follow up on the statutory notice of deficiency for that year. We also add $1,624 to the denominator, which represents the Thompsons' tax savings attributable to respondent's allowance of a 1987 personal interest deduction that was overstated by $5,814 ($27,914 - $22,100). The total denominator is thus $81,898.

$30,000/$81,898 = 36.63%

65. We do not include in that term deficiencies relating to Bauspar. See *infra* Part II.G.2.

Appendix B

G. *Additional Relief*

1. *Elimination of Non-Kersting Additions*

Although the parties' stipulation of settled issues can be read as limiting penalty relief to Kersting-related additions, see *supra* Part II.B., respondent does not dispute that implementation of the Court of Appeals' mandates includes the elimination of *all* penalties and additions, including non-Kersting-related items such as late filing additions. We agree and so hold. It seems especially incongruous to impose an addition for a few months' delay in filing a return at this time, when 25 years have passed since that delay occurred. All affected taxpayers are to be relieved of all penalties and additions to tax that were determined in their statutory notices of deficiency, not just Kersting-related items such as negligence additions.

2. *Allowance of Bauspar Deductions*

We concluded earlier that Bauspar relief was part of the Thompson settlement. See *supra* Part II.E.4. Moreover, respondent's analysis of the Bauspar program indicates that at least some of the alleged mortgage payments made to Bauspar by its borrowers would qualify for mortgage interest deductions; as respondent's counsel Henry O'Neill (O'Neill) observed: "real dollars are involved". Accordingly, we shall direct that any disallowed deductions relating to Bauspar are to be treated as valid deductions with respect to those taxpayers who may have claimed them. That's the way Bauspar played

out for the Thompsons, and so should it be for the other taxpayers before the Court against whom Bauspar-related deficiencies have been determined.

3. *Elimination of Non-Kersting Deficiencies*

Respondent indicates that perhaps 100 of the affected taxpayers have non-Kersting-related items in the deficiencies determined against them. We see no reason to treat those non-Kersting deficiencies differently from non-Kersting additions. As with those additions, the resolution of non-Kersting issues has been delayed much too long. Rule 142(a), as in effect during the years at issue, would impose upon those petitioners the burden of proving those deficiencies to be erroneous. We think it would be inherently unfair to impose upon them the risks that memories have faded and records have been lost or destroyed during the long delay in resolution of the Kersting issues, a delay primarily caused by the misconduct of respondent's attorneys. Moreover, we suspect that the non-Kersting issues are relatively minor when compared to the Kersting-related deductions that are at issue in all these cases. We therefore direct that all non-Kersting-related deficiencies determined in the notices of deficiency for all affected taxpayers with taxable years still before this Court be eliminated.

4. *Attorney's Fees*

We further recall that respondent made the somewhat empty concession that the other affected Kersting petitioners should be reimbursed for any attorney's fees

they incurred during the trial of the test cases before Judge Goffe. The concession is illusory because, as respondent acknowledges, such fees were incurred and paid by Kersting himself, not by the affected petitioners.

Respondent's facile concession gives us occasion to observe that the Court will address the matter of attorney's fees for petitioners' prosecution of these cases on appeal, as well as petitioners' attorney's fees for the conduct of the postmandate evidentiary hearing, in separate opinions and orders.

III. *Interest on Deficiencies and Overpayments*

Respondent has conceded that the accrual of interest on taxpayer deficiencies ultimately determined by this Court should be tolled as of June 1992, in accordance with the then Chief Counsel's public announcement on January 21, 2003. Petitioners, however, maintain that the accrual of interest on any deficiencies that remain after application of the Thompson settlement should be halted as of December 31, 1986--the date by which, petitioners maintain, the fraudulent McWade-DeCastro agreement was first entered into.

The protracted nature of these proceedings has exaggerated the impact of interest upon amounts that are owed by (or owed to) the affected taxpayers. Informed by this realization, at a status conference held in these cases on August 19, 2003, the Court asked respondent to compare the fiscal consequences of characterizing the Thompson settlement as (i) a 20-percent reduction in the

deficiencies determined by respondent, (ii) a 62-percent reduction, or (iii) an 80-percent reduction, with interest accruals terminated as of (a) June 1, 1992, and (b) December 31, 1986.[66]

Respondent produced figures that would approximate the overall fiscal consequences in the scenarios described above. Respondent further calculated that, if interest on the aggregate deficiencies were allowed to accrue unabated, it would amount to almost 6 times the amount of the deficiencies:

Deficiencies	$ 27,442,000
Interest through 12/31/05	155,078,215
Total	182,520,215

Respondent calculates that, in the case of a hypothetical petitioner who owes $10,000 as a result of Kersting deductions claimed for the taxable year 1980, the accrued interest payable at the end of calendar year 2005 would have been $86,336,02.

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66. On Sept. 17, 2003, Sticht, counsel for some of the nontest case petitioners, filed a motion to strike respondent's interest estimates. The Court held that motion in abeyance, without examining the estimates, until Nov. 16, 2004, when it entered an order denying Sticht's motion. We are aware of no authority indicating that the Court may not be aware of the financial consequences of the sanction it is being asked to order at the conclusion of the case before it. In the final analysis, however, in determining the sanctions to be imposed under the mandates, the Court has not been influenced by respondent's projections.

For taxpayers who prepaid the deficiencies determined against them, the results would be similarly substantial, but in their favor. For example, we have considered the effect of a 62-percent reduction in deficiencies on a hypothetical petitioner who had prepaid a deficiency for 1980 of $10,000. Our calculations indicate that, in addition to a $6,200 refund of tax, respondent would owe that taxpayer $59,728 of interest as of the close of calendar year 2005.

It is basic that accrued interest will vary depending upon the amount owed, the time the amount has been owing, and the rates at which the interest accrues. The parties differ not only over the amount owed, that is, the amount of the deficiencies, but also the time the deficiencies should be deemed to have been outstanding (there does appear to be a consensus, with which the Court agrees, that the applicable rates of interest are those prescribed pursuant to section 6621 and set forth most recently in Rev. Rul. 2005-62, 2005-38 I.R.B. 557, which adopts the tables provided in Rev Proc. 95-17, 1995-1 C.B. 556).

Inasmuch as this Court is a court of limited jurisdiction, we may exercise jurisdiction only to the extent expressly authorized by statute. Sec. 7442; *Judge v. Commissioner*, 88 T.C. 1175, 1180-1181 (1987); *Naftel v. Commissioner*, 85 T.C. 527, 529 (1985). While this Court has jurisdiction to determine deficiencies in tax pursuant to section 6214, it is well settled that such jurisdiction generally does not extend to statutory interest imposed under section 6601. See *Bax v. Commissioner*, 13 F.3d 54, 56-57 (2d Cir. 1993);

Pen Coal Corp. v. Commissioner, 107 T.C. 249, 255 (1996); *LTV Corp. v. Commissioner*, 64 T.C. 589, 597 (1975); see also *Betz v. Commissioner*, 90 T.C. 816, 823 (1988); *Asciutto v. Commissioner*, T.C. Memo. 1992-564, affd. 26 F.3d 108 (9th Cir. 1994). Section 6601(e)(1) expressly provides that interest prescribed by section 6601 is treated as tax "except [for purposes of] subchapter B of chapter 63, relating to deficiency procedures". Because this exception excludes interest from the definition of "tax" for purposes of section 6211(a) (defining the term "deficiency"), it follows that such interest is not treated as part of the underlying deficiency. See *White v. Commissioner*, 95 T.C. 209, 213 (1990).

In contrast, as we recognized in *Lincir v. Commissioner*, 115 T.C. 293, 298 (2000), affd. 32 Fed. Appx. 278 (9th Cir. 2002), section 6601(e) does not curtail our jurisdiction over interest on overpayments of taxes. Instead, the Court does have jurisdiction to redetermine statutory interest where a taxpayer has properly invoked the Court's overpayment jurisdiction pursuant to section 6512. The cases before the Court, however, involve both interest owed by petitioners on deficiencies, over which we arguably lack jurisdiction, and interest owed by respondent on overpayments, over which we clearly have jurisdiction.

This possible divergence in our jurisdictional authority has the potential, at least, for interfering with our execution of the mandates of the Court of Appeals, which, we believe, require relief not only to taxpayers to

whom respondent owes interest, but also to taxpayers who owe interest to respondent.[67]

We are given further pause by the holding of the Supreme Court in *Commissioner v. McCoy*, 484 U.S. 3 (1987). In *McCoy*, the Court of Appeals for the Sixth Circuit issued an unpublished order following its affirmance--809 F.3d 333 (6th Cir. 1987), affg. T.C. Memo. 1985-509--of the Tax Court's denial of special use estate tax valuation. In its order, the Court of Appeals had granted the taxpayer's request for relief from interest and penalties, which "now exceed the assessed tax" and ordered the Tax Court to forgive the interest and penalties "in order to achieve a fair and just result." *Id.* at 5-6. In a per curiam opinion, Justice Marshall dissenting, the Supreme Court held that the Court of Appeals had exceeded its jurisdiction in ordering the Tax Court to forgive interest on the determined deficiency in estate tax and to forgive the statutorily imposed late payment penalty. In so doing, the Supreme Court observed:

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67. The Court is concerned about the parties' stipulation filed on June 22, 2005, wherein they apparently seek to remove from this Court's consideration the issue of whether any remittance by an affected taxpayer is an (interest bearing) advance payment or a (non-interest bearing) cash bond. This Court is not bound by such stipulation. We believe the mandates of the Court of Appeals require that interest be paid to all affected taxpayers who made remittances with respect to Kersting deficiencies, as was the case with the Thompsons. Inasmuch as we have jurisdiction over interest on overpayments, we shall direct respondent to compute and pay such interest to all affected taxpayers who made remittances with respect to the deficiencies that had been determined against them.

> Plainly, the court of appeals lacks jurisdiction to decide an issue that was not the subject of the Tax Court proceeding or to grant relief that is beyond the powers of the Tax Court itself. [*Id.* at 6.]

We conclude our discussion of *McCoy* by noting, as does respondent, that the Supreme Court, in overruling the forgiveness of a generally applicable statutory interest accrual on deficiencies under section 6601 by the Court of Appeals for the Sixth Circuit, had no occasion to address a court's inherent authority to impose sanctions in a case of Government misconduct.

Moreover, in *Estate of Branson v. Commissioner*, 264 F.3d 904 (9th Cir. 2001), the Court of Appeals for the Ninth Circuit adopted an expansive view of the Tax Court's equitable or inherent powers. The court stated:

> "the Tax Court exercises its judicial power in much the same way as the federal district courts exercise theirs." *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868, 891, 111 S.Ct. 2631, 115 L.Ed.2d 764 (1991). This includes the authority to apply the full range of equitable principles generally granted to courts that possess judicial powers. "Even if the Tax Court does not have far-reaching general equitable powers, it can apply equitable principles and exercise equitable powers within its own jurisdictional competence." *Estate of Ashman v. Commissioner of Internal Revenue*, 231

> F.3d 541, 545 (9th Cir. 2000); See also *Kelley [v. Commissioner]*, 45 F.3d [348] at 352 [(9th Cir. 1995)] (Tax Court has equitable power to reform agreements between taxpayer and IRS); *Buchine v. Commissioner of Internal Revenue Service*, 20 F.3d 173, 178 (5th Cir. 1994) (holding that the Tax Court had the authority to apply the "equitable principle of reformation to a case over which it had jurisdiction"). [*Id.* at 908-909.]

It would appear that, in issuing its opinion and mandates in Dixon V, the Court of Appeals for the Ninth Circuit, consistent with its opinion in *Commissioner v. Branson*, *supra*, adopted the view that the Tax Court had and has equitable power to resolve the situation then before it, and now before us.

More to the point, we regard respondent's concession not to collect interest on deficiencies that would otherwise accrue beyond June 1992 as an appropriately targeted response to the consequences of his former attorneys' fraud on the court, which caused substantial delay in the resolution of the Kersting project cases.[68] We have respondent's assurance that he will give effect to the

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68. On May 14, 1992, test case petitioners Dixon, DuFresne, Young, and Hongsermeier had already appealed their test cases, before the misconduct of respondent's attorneys was discovered and disclosed. It is reasonable to assume that the conduct of their appeals would have caused a delay of at least 1 or 2 years before the Kersting project test cases would have been finally decided, even if there had been no such misconduct. In these circumstances, we would not be inclined, even if our power to do so were clear, to cancel or abate interest as of an earlier date than respondent has conceded.

concession; we are satisfied he will do so. Moreover, in accepting and endorsing respondent's concession, we need not and do not reach petitioners' argument that the Tax Court has the power and obligation to abate or cancel interest on deficiencies as of an earlier date.[69]

In the unlikely event respondent fails to give effect to the concession (or if there is a dispute about how the concession is to be applied), there will be time enough to consider whether and how to address the matter in a collection action or other appropriate proceeding.

To give effect to the foregoing,

Decisions will be entered under Rule 155.

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69. In any event, we reject petitioners' citation and discussion of *United States v. Verdugo-Urquidez*, 856 F.2d 1214, 1231 (9th Cir. 1988) (Wallace, J., dissenting), revd. 494 U.S. 259 (1990) and *Riggs v. Palmer*, 22 N.E. 188, 190 (N.Y. App. Ct. App. 1889), as authorizing (or even suggesting) the proposition that accrual of interest on Kersting-related deficiencies as they have been reduced by our application of the mandates should cease as of Dec. 31, 1986, the date petitioners argue the fraud commenced.

Petitioners also argue that interest should not continue to accrue beyond Dec. 31, 1986, because the result of the final settlement arrived at in 1989 was to convert the interest payments made by the Thompsons as of Dec. 31, 1986, into payments of tax that satisfied their agreed tax liabilities and stopped any further accrual of interest against them. It suffices to point out that the Thompsons made the necessary payments around the end of 1986. Those petitioners who remain in a deficiency/ underpayment posture under the mandates made no such payments, and interest on their reduced deficiencies therefore continued to accrue until the effective date of respondent's concession.

APPENDIX C — SUPPLEMENTAL MEMORANDUM OPINION OF THE UNITED STATES TAX COURT, FILED SEPTEMBER 7, 2006

UNITED STATES TAX COURT

Docket Nos. 9382-83, 10588-83, 17642-83, 17646-83, 27053-83, 4201-84, 10931-84, 15907-84, 20119-84, 28723-84, 38757-84, 38965-84, 40159-84, 22783-85, 30010-85, 30979-85, 29643-86, 35608-86, 13477-87, 479-89, 8070-90, 19464-92, 621-94, 7205-94, 9532-94, 17992-95, 17993-95.

T.C. Memo. 2006-190

JERRY AND PATRICIA A. DIXON, ET AL.,[1]

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

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1. This Memorandum Opinion supplements *Dixon v. Commissioner*, T.C. Memo. 2006-90. Cases of the following petitioners have been treated as related to the above-captioned case for purposes of giving effect to the mandates of the Court of Appeals for the Ninth Circuit in *Dixon v. Commissioner*, 316 F.3d 1041, 1047 (9th Cir. 2003), as amended Mar. 18, 2003 (Dixon V), revg. and remanding T.C. Memo. 1999-101 (Dixon III): Robert H. and Barbara A. Gridley, docket Nos. 10588-83, 10931-84, 38757-84; Norman W. and Barbara L. Adair, docket Nos. 17642-83, 38965-84, 35608-86, 479-89, 8070-90; Ronald L. and Mattie L.

Appendix C

SUPPLEMENTAL MEMORANDUM OPINION

BEGHE, *Judge*: These cases continue before the Court on petitioners Richard and Fiorella Hongsermeier's motion under Rule 161[2] for reconsideration of our Memorandum Opinion in T.C. Memo. 2006-90 (Dixon VI). Petitioners' motion arises from litigation using a test case procedure that resulted in *Dixon v. Commissioner*, T.C. Memo. 1991-614 (Dixon II), vacated and remanded sub nom. *DuFresne v. Commissioner*, 26 F.3d 105 (9th Cir. 1994), on remand *Dixon v. Commissioner*, T.C. Memo. 1999-101 (Dixon III), supplemented by T.C. Memo. 2000-116 (Dixon IV), revd. and remanded 316 F.3d 1041 (9th Cir. 2003) (Dixon V). On the ensuing remand, Dixon VI responded to the Dixon V primary mandate with regard to the sanction imposed against respondent; and *Dixon v. Commissioner*, T.C.

Alverson, docket No. 17646-83; Russell L. Fleer, Sr., and Sally A. Fleer, docket Nos. 27053-83 and 13477-87; Hoyt W. and Barbara D. Young, docket Nos. 4201-84, 22783-85, 30010-85; Robert L. and Carolyn S. DuFresne, docket Nos. 15907-84, 30979-85; John L. and Terry E. Huber, docket No. 20119-84; Arden L. and Barbara G. Blaylock, docket No. 28723-84; Terry D. and Gloria K. Owens, docket No. 40159-84; Richard and Fiorella Hongsermeier, docket No. 29643-86; Willis F. McComas II and Marie D. McComas, docket No. 19464-92; Wesley Armand and Sherry Lynn Cacia Baughman, docket No. 621-94; Joe A. and JoAnne Rinaldi, docket No. 7205-94; Norman A. and Irene Cerasoli, docket No. 9532-94; Stanley C. and Sharon A. Titcomb, docket No. 17992-95; Richard B. and Donna G. Rogers, docket No. 17993-95. The 27 related cases have been consolidated for briefing and opinion.

2. Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code of 1986.

Memo. 2006-97 (Dixon VII), and *Young v. Commissioner*, T.C. Memo. 2006-189, responded to the Dixon V ancillary mandate with regard to petitioners' appellate attorney's fees and costs incurred in Dixon V.

In Dixon V, as a sanction against respondent for the fraud on the court perpetrated by respondent's attorneys in the trial of the test cases that had resulted in the decisions in favor of respondent against the test case petitioners in Dixon II, the Court of Appeals mandated that "terms equivalent to those provided in the settlement agreement" between the IRS and test case petitioners John R. and Maydee Thompson (the Thompsons) be extended to test case petitioners and all other taxpayers properly before that court. *Dixon v. Commissioner*, 316 F.3d at 1047. It left to this Court's "discretion the fashioning of such judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided for in the Thompson settlement." *Id.* n.11.

Petitioners primarily ground their motion for reconsideration of Dixon VI, regarding the sanction to be imposed on respondent, on allegations that respondent engaged in attempts at a continued coverup of the fraud of respondent's attorneys and that this Court did not properly address that alleged continued misconduct in Dixon VI.[3] Petitioners ask the Court to reopen the

3. Petitioners in their motion also ask us to change two holdings of our Dixon VI opinion, our handling of the Thompsons' sec. 6651(a) late-filing addition, and the cutoff date of deficiency interest accruals against Kersting project petitioners, described

record in Dixon VI and impose additional sanctions on respondent for respondent's alleged continued misconduct. Because the Court is considering similar allegations by other taxpayers in motions for leave to file motions to vacate stipulated decisions that were never appealed and have become final, we granted petitioners' motion for reconsideration and ordered and received respondent's response to petitioners' motion. However, we conclude in this Supplemental Memorandum Opinion that the law of the case and the primary mandate of the Court of Appeals in Dixon V preclude us in the cases at hand from conducting any further inquiry into respondent's misconduct and from imposing any additional sanction on respondent with respect to cases of taxpayers, including petitioners, who were properly before that court.[4]

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infra in text following note 9 as items (3) and (4). Petitioners made their arguments on these issues in their opening brief, and Dixon VI adequately addresses them. Consequently, we decline to change our handling of the 1981 latefiling addition or the cutoff date on the deficiency interest accruals. See *Estate of Quick v. Commissioner*, 110 T.C. 440, 441 (1998).

4. We note that the law of the case and the mandates of the Court of Appeals for the Ninth Circuit in Dixon V do not preclude this Court from making such an inquiry in addressing motions for leave to file motions to vacate stipulated decisions filed by taxpayers who were not properly before the Court of Appeals. See, e.g., motions for leave filed by Jesse M. and Lura L. Lewis in docket Nos. 15673-87, 18551-88, 29429-88, regarding *Lewis v. Commissioner*, T.C. Memo. 2005-205 (motion for reconsideration pending).

Appendix C

Background

For purposes of this motion, we incorporate our findings in Dixon III and IV, as modified by Dixon V and VI. We begin by setting forth the background pertinent to this Supplemental Memorandum Opinion.

Respondent determined deficiencies and additions to tax against petitioners and other taxpayers who participated in tax shelter programs (the Kersting project) promoted by Henry F.K. Kersting (Kersting). Respondent's determinations resulted in the commencement in this Court of more than 1,800 cases arising from the disallowance of deductions claimed by participants in the Kersting programs. Most such participants who filed petitions in this Court signed "piggyback agreements" with respondent, agreeing to be bound by the outcome of test cases that had been selected by respondent's trial attorney and Brian Seery (Seery), the attorney originally retained by Kersting to provide representation in the Tax Court to participants in his programs.

Following Seery's withdrawal, Kersting engaged Robert J. Chicoine (Chicoine) and Darrell D. Hallett (Hallett) to represent the participants in his programs in the Tax Court. Some such participants, including the Thompsons (who were test case petitioners), separately retained Luis C. DeCastro (DeCastro) to represent them in the Tax Court.

DeCastro obtained 20-percent reduction settlements on behalf of some of the Kersting project participants

he represented, as did Chicoine and Hallett on behalf of other nontest case petitioners. Chicoine and Hallett disclosed the 20-percent reduction settlement to the test case and nontest case petitioners who had inquired about the possibility of a more advantageous settlement than the 7-percent reduction project settlement respondent had been offering.

Chicoine and Hallett's settlement efforts displeased Kersting. Kersting fired Chicoine and Hallett and retained Joe Alfred Izen, Jr. (Izen), to try the Kersting project test cases on behalf of the petitioners.

Before the trial of the Kersting project test cases, DeCastro, on behalf of the Thompsons, and respondent's trial attorney, Kenneth W. McWade (McWade), with his immediate supervisor, William A. Sims (Sims), agreed to a secret settlement they did not disclose to respondent's management, the attorneys or other test case petitioners, or the Tax Court. The purpose and effect of this settlement was to provide refunds to the Thompsons that were used to pay DeCastro's attorney's fees to represent the Thompsons in the test case trial as consideration for the Thompsons' staying in the test case array and Mr. Thompson's testifying at the test case trial.

McWade also entered into a secret pretrial settlement with pro se test case petitioners John R. and E. Maria Cravens (the Cravenses) that was much less advantageous to them than the Thompson settlement was to the Thompsons or the 20-percent reductions obtained by DeCastro and by Chicoine and Hallett was to other

Kersting program participants. The Cravens settlement was on the order of but slightly less advantageous to the Cravenses than respondent's 7-percent reduction project settlement offer, which had been available to Kersting project participants during 1982 through 1988.

In Dixon II, the Court sustained almost all of respondent's deficiency determinations in the test cases. After the Court entered decisions for respondent in the test cases in accordance with Dixon II, respondent's management discovered the Thompson and Cravens settlements and disclosed them to the Court. On June 9, 1992, respondent filed motions for leave to file motions to vacate the decisions entered against the Thompsons, the Cravenses, and another test case petitioner, Ralph J. Rina (Rina). Respondent asked the Court to conduct an evidentiary hearing to determine whether the undisclosed agreements with the Thompsons and the Cravenses had affected the trial of the test cases or the opinion of the Court. In the meantime (on May 14, 1992), the other test case petitioners, who continued to be represented by Izen, had appealed the Court's decisions against them.

On June 22, 1992, the Court granted respondent's motions to vacate the decisions filed in the Thompson and Cravens cases and denied respondent's request for an evidentiary hearing. By order dated June 22, 1992, the Court also denied respondent's motion to vacate the decision against Rina, on the ground that the testimony, stipulated facts, and exhibits relating to the Thompson and Cravens cases had no material effect on the Court's Dixon II opinion as it related to Rina.

Appendix C

On July 22, 1992, Izen filed a motion for reconsideration of the Court's order denying respondent's motion to vacate the decision in the Rina case. By order dated August 4, 1992, the Court denied Izen's motion for reconsideration.[5]

On July 16, 1992, DeCastro had filed a motion for entry of decision in favor of the Thompsons in accordance with the terms of their settlement with respondent. Respondent's motion for entry of decision and supporting memorandum in opposition to DeCastro's motion for entry of decision disclosed to the Court the facts that had been uncovered in respondent's investigation. These included the fact that the purpose and effect of the Thompson settlement was to provide refunds to the Thompsons that were used to pay DeCastro's attorney's fees to represent the Thompsons as consideration for staying in the test case array and Mr. Thompson's testifying at the test case trial. The Court entered decisions in favor of the Thompsons and the Cravenses in accordance with their settlements but allowed the adverse decisions against other test case petitioners to stand.

Thereafter, Izen and Robert Patrick Sticht (Sticht), on behalf of various nontest case petitioners, filed separate motions with the Court to intervene in the Thompson

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5. Rina appealed this denial. Unlike the Thompsons and the Cravenses, Rina had no settlement agreement with respondent's trial attorney. On June 13, 1995, Rina agreed to the entry of a stipulated decision in the amounts originally determined in his statutory notice of deficiency.

and Cravens cases. The Court denied these motions to intervene.[6]

In January 1993, after respondent's management had discovered the Thompson settlement and disclosed it to the Court and while the other test cases were on appeal, respondent made a project settlement offer to nontest case petitioners. This offer, which in effect reinstated respondent's earlier project settlement offer to reduce Kersting deficiencies by 7 percent, was substantially less advantageous to petitioners than the Thompson

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6. Neither the Thompsons nor the Cravenses appealed the decisions giving effect to their settlements. Izen and Sticht separately appealed the orders denying their motions to intervene in the Thompson and Cravens cases on behalf of the nontest case petitioners in various courts, including the Courts of Appeals for the Second, Ninth, and Tenth Circuits. All appeals in the Thompson and Cravens cases eventually were dismissed. In an unpublished opinion filed June 15, 1994, the Court of Appeals for the Ninth Circuit stated:

> The Tax Court's August 25 and 26, 1992 decisions entering settlement in the Cravens and Thompson cases, respectively, are final. 26 U.S.C. § 7481(a)(1); Fed. R. App. P. 13. The Tax Court lacks jurisdiction to vacate those decisions. *Billingsley v. CIR*, 868 F.2d 1081, 1084 (9th Cir. 1989). Because there is no case remaining in which the taxpayers can intervene, this appeal is moot. [*Adair v. Commissioner*, 26 F.3d 129 (9th Cir. 1994).]

settlement. More than 400 nontest case petitioners accepted respondent's reinstated project settlement offer.[7]

On appeal, the test case petitioners represented by Izen argued that the trial of the test cases had been tainted by the Thompson and Cravens settlements. The Court of Appeals for the Ninth Circuit agreed, vacating the decisions in the remaining test cases and remanding them to this Court with directions "to conduct an evidentiary hearing to determine the full extent of the admitted wrong done by the government trial lawyers." *DuFresne v. Commissioner*, 26 F.3d at 107. The Court of Appeals, citing *Arizona v. Fulminante*, 499 U.S. 279, 309 (1991), directed the Court to consider "whether the extent of misconduct rises to the level of a structural defect voiding the judgment as fundamentally unfair, or whether, despite the government's misconduct, the judgment can be upheld as harmless error." *Id.* Further, the Court of Appeals directed this Court to consider on the merits all motions of intervention filed by affected parties. See *id.*

For purposes of the evidentiary hearing mandated by the Court of Appeals in *DuFresne*, and to give effect to the direction of the Court of Appeals regarding intervention, this Court ordered that the cases of 10 nontest case petitioners, one docket represented by Izen, some

7. There were approximately 100 cases that had settled before the discovery and disclosure of the misconduct of respondent's attorneys, encompassing both the original project settlement offer (7-percent reductions) and other settlements obtained by DeCastro and by Chicoine and Hallett (on the order of 20-percent reductions).

represented by Sticht, and others by Robert Alan Jones (Jones), be consolidated with the remaining test cases. [8]

During the course of the evidentiary hearing mandated by the Court of Appeals in *DuFresne*, Izen sought discovery of documents regarding respondent's conduct following the trial of the test cases. Izen alleged, inter alia, that respondent's activities after May 1992 amounted to an effort to cover up the fraudulent conduct of the Government attorneys in the test cases. The Court denied Izen's discovery requests. See Dixon III, sec. III C.

In Dixon III, this Court held that the misconduct of McWade and Sims in arranging and failing to disclose the Thompson settlement did not create a structural defect but instead resulted in harmless error. In Dixon III, the Court nevertheless imposed sanctions against respondent, holding that Kersting program participants who had not had final decisions entered in their cases would be relieved of liability for the interest component of the addition to tax for negligence under section 6653(a)(1)(B), and incremental interest attributable to the increased rate prescribed in section 6621(c). In Dixon IV, the Court awarded additional sanctions against respondent by awarding petitioners attorney's fees and costs under section 6673(a)(2) but declined to impose any further sanctions.

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8. The nontest cases that were consolidated with the remaining test cases for purposes of the evidentiary hearing initially included petitioners represented by Declan J. O'Donnell. Those petitioners, however, dropped out and did not participate in the evidentiary hearing, choosing instead to file a motion for summary judgment to obtain the benefit of the Thompson settlement. The Court denied the motion in *Gridley v. Commissioner*, T.C. Memo. 1997-210.

Appendix C

Test case and nontest case petitioners appealed. Izen, in his brief to the Court of Appeals, argued not only that the misconduct of respondent's attorneys was a fraud on the court, but also that the Tax Court had abused its discretion by denying petitioners' discovery requests related to allegations of respondent's continued misconduct after the trial of the test cases. Although the Court of Appeals did not address Izen's discovery arguments in its opinion, it commented that respondent's disclosure of respondent's attorneys' misconduct "was anything but complete". *Dixon v. Commissioner*, 316 F.3d at 1045 n.8.

In Dixon V, the Court of Appeals concluded that "the misconduct, including its persistence and concealment, did indeed amount to a fraud on the court." *Id.* at 1043. As a sanction against respondent for the misconduct, the Court of Appeals mandated that "terms equivalent to those provided in the settlement agreement with [the Thompsons] and the IRS" be extended to "Appellants [test case petitioners] and all other taxpayers properly before this Court". *Id.* at 1047. Notably, the Court of Appeals did not find that this Court's evidentiary hearing or findings of fact on the misconduct of respondent's attorneys were inadequate or did not otherwise comply with its mandate in *DuFresne*. Nor did the Court of Appeals address much less find error in this Court's denial of Izen's discovery requests or order us to conduct an evidentiary hearing regarding the continued misconduct alleged by Izen.

During the proceedings on remand from the Court of Appeals opinion in Dixon V, this Court, in an order issued October 12, 2004, allowed petitioners' renewed discovery

requests (that the Court had originally denied in the proceedings on remand from *DuFresne*) for the limited purpose of ascertaining respondent's understanding of the origins and nature of the Thompson settlement. With one exception,[9] the Court ordered the production of the more than 200 documents and items encompassed by respondent's privilege log, as being relevant to that purpose.

In Dixon VI, we held that: (1) The final Thompson settlement is to be regarded as resulting in a 63.37-percent reduction of the Thompsons' deficiencies, as well as elimination of all Kersting-related penalties and

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9. This Court sustained respondent's invocation of the deliberative process privilege to deny petitioners access to the material described in item 123 of respondent's privilege log, because the material was not probative of respondent's understanding of the origins and nature of the Thompson settlement. Item 123 consisted of a chronological file of 16 volumes comprising more than 1,200 items and 5,000 pages created and maintained by respondent's counsel Henry E. O'Neill (O'Neill). However, in note 2 of the Oct. 12, 2004, order, the Court anticipated and cautioned that the documents and materials in item 123 might be required to be produced at some later time in connection with pending and proposed motions for leave to file motions to vacate decisions in cases in which stipulated decisions have been entered that may raise questions regarding the adequacy of respondent's disclosure of the misconduct of McWade and Sims and the procedural status of the test cases. That subject will be addressed in pending proceedings on the motions for leave to file motions to vacate stipulated decisions entered in response to respondent's project settlement offer of January 1993 and other settlements of Kersting project cases. See *supra* note 4.

additions; (2) the Thompson settlement encompasses and requires the vacating of the portion or portions of the deficiencies determined against any petitioners that may be attributable to the "Bauspar" shelter that was also promoted by Kersting; (3) the Thompson settlement's cancellation of the Thompsons' 1981 late-filing addition justifies cancellation of not only all non-Kersting-related penalties and additions but also all other substantive adjustments not arising from shelters promoted by Kersting; (4) interest on the reduced deficiencies shall not be charged beyond the date in June 1992 fixed by respondent's concession and shall not be stopped as of any earlier date, such as December 1986, which petitioners contend marked the inception of the fraud on the court.

Discussion

In their motion for reconsideration, petitioners ask the Court to investigate and impose sanctions on respondent for alleged misconduct that occurred after the trial of the test cases.

Petitioners argue that there is substantial newly discovered evidence that respondent's management made misrepresentations to cover up the extent of the fraud of respondent's trial attorneys and to distort the facts in pleadings filed with this Court in order to reduce the Government's monetary exposure and contain respondent's public embarrassment and accountability. Petitioners ask the Court to conduct a further inquiry into respondent's alleged coverup misconduct and to impose additional sanctions on respondent for that misconduct.

Respondent counters that, upon receiving the mandate of an appellate court, the lower court cannot vary it or examine it for any purpose other than execution, and that the Tax Court has fully complied in Dixon VI with the mandate of the Court of Appeals in Dixon V. We agree with respondent.

The Courts of Appeals have exclusive jurisdiction to review the decisions of the Tax Court in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury. Sec. 7482(a)(1). Upon such review, the Courts of Appeals "have power to affirm or, if the decision of the Tax Court is not in accordance with law, to modify or to reverse the decision of the Tax Court, with or without remanding the case for a rehearing, as justice may require." Sec. 7482(c)(1).

Generally, perfection of an appeal of a decision or certification transfers jurisdiction of the case to the Court of Appeals; i.e., the jurisdiction of the trial court ceases and that of the Court of Appeals begins. *Griggs v. Provident Consumer Disc. Co.*, 459 U.S. 56, 58 (1982). Once an appeal is commenced, the trial court generally does not have authority to act upon matters relating to the subject matter of the appeal until the mandate from the appellate court is returned.[10] *Hunter Douglas Corp.*

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10. There are limited exceptions to this general rule. Even though an appeal of a judgment is pending in the Court of Appeals, "the lower court may retain jurisdiction over certain matters, without appellate court approval or sanction," e.g., matters that are "collateral to the appeal, in aid of the appeal, to correct clerical mistakes, in aid of execution of a judgment that has not been

v. Lando Prods., Inc., 235 F.2d 631, 632-633 (9th Cir. 1956); *Pollei v. Commissioner*, 94 T.C. 595, 600 (1990). Once an appellate court returns its mandate, jurisdiction over the case revests in the trial court. *United States v. Cote*, 51 F.3d 178, 182 (9th Cir. 1995). Under the law of the case doctrine and the rule of mandate, the trial court's authority to address any issues after an appeal is completed is generally limited by any action taken by the appellate court with respect to those issues during the appeal.

> On remand, a trial court may not deviate from the mandate of an appellate court * * * "[w]hen a case has been decided by an appellate court and remanded, the court to which it is remanded must proceed in accordance with the mandate and such law of the case as was established by the appellate court." *Firth v. United States*, 554 F.2d 990, 993 (9th Cir. 1977) * * * The Supreme Court long ago emphasized that when acting under an appellate court's mandate, an inferior court "cannot vary it, or examine it for any other purpose than execution; or give any other or further relief; or review it, even for apparent error, upon any matter decided upon appeal; or intermeddle with it, further than to settle so much as has been remanded." *In re Sanford Fork & Tool Co.*, 160 U.S. 247, 255 (1895). [*Commercial Paper*

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superseded, and to maintain the status quo between the parties pending the appeal." *Pollei v. Commissioner*, 94 T.C. 595, 600 (1990).

Appendix C

Holders v. Hine (In re Beverly Hills Bancorp), 752 F.2d 1334, 1337 (9th Cir. 1984); alteration in the original.]

The "law of the case" doctrine requires a decision on a legal issue by an appellate court to be followed in all subsequent proceedings in the same case. *Herrington v. County of Sonoma*, 12 F.3d 901, 904 (9th Cir. 1993). The doctrine generally precludes reexamination of issues decided either expressly or by necessary implication by the appellate court upon appeal and applies to the trial court on remand and even to the appellate court itself upon a subsequent appeal. *Pollei v. Commissioner, supra* at 601. The law of the case acts as a bar only when the issue in question was actually considered and decided by the first court and does not extend to issues an appellate court did not address. *United States v. Cote, supra* at 181-182.

Upon remand of the case, a corollary of the law of the case doctrine, known as the rule of mandate, requires the lower court to implement both the letter and the spirit of the appellate court's mandate. The rule of mandate is similar to, but broader than, the law of the case doctrine and prohibits the lower court from disregarding the appellate court's explicit directives. *Herrington v. County of Sonoma, supra* at 904. The lower court, upon receiving the mandate of an appellate court "cannot vary it or examine it for any other purpose than execution". *In re Sanford Fork & Tool Co., supra* at 255. The appellate court's mandate controls all matters within its scope, and the trial court cannot give relief beyond the scope of the mandate. *Newball v. Offshore Logistics Intl.*, 803 F.2d 821,

826 (5th Cir. 1986). Thus, a lower court cannot revisit its already final determinations unless the mandate allows it. *United States v. Lewis*, 862 F.2d 748, 750 (9th Cir. 1988).

While a mandate controls all matters within its scope, on remand a lower court is free to consider any issue not foreclosed by the mandate. *United States v. Kellington*, 217 F.3d 1084 (9th Cir. 2000). Under certain circumstances, the lower court may issue an order on remand that deviates from the mandate provided "it is not counter to the spirit of the * * * [appellate] court's decision". *Lindy Pen Co. v. Bic Pen Corp.*, 982 F.2d 1400, 1404 (9th Cir. 1993).

In Dixon V, the Court of Appeals considered the misconduct of respondent's attorneys in the test cases, determined that the misconduct constituted fraud on the court, and formulated the appropriate sanction. The Court of Appeals then mandated that this Court enter decisions in these cases on "terms equivalent to those provided in the settlement agreement with [the Thompsons] and the IRS". *Dixon v. Commissioner*, 316 F.3d at 1047. We must therefore consider whether the issue of respondent's alleged continued misconduct following the trial of the test cases was addressed and disposed of in a prior proceeding so that the Dixon V mandates foreclosed further inquiry into that subject. See *Sprague v. Ticonic Natl. Bank*, 307 U.S. 161, 164 (1939).

In *DuFresne v. Commissioner*, 26 F.3d at 107, the Court of Appeals required the Tax Court to "conduct an evidentiary hearing to determine the full extent of the

admitted wrong done by the government trial lawyers." During the course of the evidentiary hearing required by the Court of Appeals in *DuFresne*, Izen sought discovery of documents regarding respondent's conduct following the trial of the test cases, alleging that respondent attempted to "cover up" the fraudulent conduct of the Government attorneys in the test cases. Following the evidentiary hearing mandated by *DuFresne*, this Court issued two opinions, Dixon III and Dixon IV, addressing sanctions against respondent.

In their motion for reconsideration, petitioners complain that during the course of the evidentiary hearing conducted on remand from the Court of Appeals, as required by *DuFresne*, this Court denied them access to Government documents that showed the extent of respondent's continued misconduct in attempting to conceal the trial attorneys' misconduct. Our decisions entered in accordance with Dixon III and Dixon IV, however, were appealed. Izen, in his brief on appeal, argued to the Court of Appeals that the Tax Court abused its discretion by denying petitioners' discovery requests related to respondent's conduct following the trial.[11] Although the Court of Appeals did not address Izen's discovery arguments in its Dixon V opinion, it referred to the "persistence and concealment of the misconduct",

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11. In the Court's evidentiary proceedings on the Dixon V mandate, the Court required the production of the bulk of the materials to which petitioners had been previously denied access, as a means of helping the Court to ascertain "respondent's understanding of the origins and nature of the Thompson settlement." See *supra* notes 4 and 9 and accompanying text.

Dixon v. Commissioner, 316 F.3d at 1043, and commented that respondent's disclosure of the misconduct "was anything but complete". *Id.* at 1047 n.8. In formulating the Thompson settlement sanction mandated by Dixon V, the Dixon V panel was aware and took into account that respondent's conduct following the trial of the test cases had been less than exemplary.

The alleged misconduct of respondent's managers following the trial of the test cases was directly in issue in the prior proceedings before the Court of Appeals and before this Court. We therefore hold that the issue in the cases at hand was covered by necessary implication by the opinion of the Court of Appeals in Dixon V and by its most recent primary mandate. Consequently, the Dixon V mandate bars this Court from considering petitioners' requests in the cases at hand to conduct a further inquiry into respondent's alleged continued misconduct and to impose sanctions against respondent for misconduct alleged to have occurred following the trial, opinion, and original decisions in the test cases.

Petitioners do not argue in their motion for reconsideration that further inquiry into respondent's alleged continued misconduct would be necessary or helpful in obtaining a better or more accurate sense of the terms and application of the Thompson settlement. Nor do we believe such an inquiry would have any such effect. In these circumstances, to engage in a further inquiry in the cases at hand (which encompass all pending cases in the Kersting project in which final decisions have not been entered) with a view to imposing additional sanctions on

respondent would be inconsistent with and beyond the scope of the mandate of the Court of Appeals in Dixon V. The decision by the Court of Appeals in Dixon V not to address Izen's complaints about this Court's restraints on his discovery efforts--which have been largely mooted by the Court's discovery rulings in the most recent evidentiary hearings--buttresses this conclusion.

To reflect the foregoing,

Decisions will be entered under Rule 155.

APPENDIX D — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT, FILED JANUARY 17, 2003

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 00-70858

IRS Nos., 29643-86, 30979-85, 30010-85, 22783-85, 40159-84, 15907-84, 4201-84, 9382-83

JERRY A. DIXON, HOYT W. & BARBARA D. YOUNG, ROBERT L. & CAROLYN S. DU FRESNE, TERRY D. & GLORIA K. OWENS, RICHARD & FEDELLA HONGSERMEIER, *et al.*; PATRICIA A. DIXON,

Petitioners,

RICHARD HONGSERMEIER; FIDELLA HONGSERMEIER; TERRY D. OWENS,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Appeal from a Decision of the United States Tax Court

Argued and Submitted October 10, 2002—San Francisco, California

Filed January 17, 2003

Appendix D

Before: Dorothy W. Nelson, Michael Daly Hawkins and Kim McLane Wardlaw, Circuit Judges.

Opinion by Judge Hawkins

OPINION

HAWKINS, Circuit Judge:

"Truth needs no disguise."[1]

We must decide whether the Tax Court's finding of a pattern of government misconduct amounts to a fraud on the court and, if so, whether such a fraud requires a showing of prejudice to justify relief. We conclude that the misconduct, including its persistence and concealment, did indeed amount to a fraud on the court. Consistent with Supreme Court authority and the law of this Circuit, we hold that no showing of prejudice is required and, for the reasons that follow, we reverse the Tax Court determination that these taxpayers are not entitled to relief.

FACTUAL BACKGROUND & PROCEDURAL HISTORY

During the 1970s and 1980s, a group of individual taxpayers participated in an investment program and tax shelter designed and administered by Honolulu

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1. Justice Hugo Black in *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238, 247 (1944), *overruled on other grounds by Standard Oil v. United States*, 429 U.S. 17, 18 (1976).

businessman Henry Kersting ("Kersting"). The investments, which came to bear Kersting's name, consisted of a somewhat complicated program in which participants purchased stock with loans from Kersting-controlled entities financed by two layers of promissory notes.[2] Kersting marketed the product as a legitimate investment which would enable participants to claim interest deductions on their individual tax returns. When Kersting participants claimed those deductions,[3] the IRS issued notices of deficiency, disallowing all interest deductions taken, and reasoning that the underlying transactions were shams, the interest was not "paid or properly accrued," and the notes did not constitute a bona fide indebtedness.

In a Tax Court action brought by Kersting on their behalf, program participants sought a redetermination of the deficiencies. Recognizing that the sheer number of affected taxpayers (approximately 1,800) made it impractical to try each case individually, the parties agreed to employ a "test case" approach to determine

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2. The Kersting investment consisted of the following: (i) corporate stock or stock subscription rights or investment certificates purchased by a loan from a Kersting company (a "Primary Note"); (ii) prepayment of interest on the Primary Note financed by a secondary or "leverage" note from another Kersting entity at a lower interest rate than the Primary Note; (iii) principal on the Primary Note paid by surrender of the stock or other underlying asset; and (iv) interest on the Primary Note paid by a distribution from the corporation whose stock was purchased with the Primary Note. *Dixon v. Comm'r*, 62 T.C.M. (CCH) 1440, 1454-62 (1991) (original Tax Court opinion).

3. Deductions were claimed pursuant to 26 U.S.C. § 163.

liability. To facilitate this process, the bulk of affected taxpayers signed stipulations ("piggyback agreements") agreeing to be bound by the decision of a test case trial involving representative taxpayers. The agreed-upon process provided that two representatives would be chosen by the taxpayers' attorneys and five by IRS attorneys. Approximately 1,300 taxpayers, some 500 already having settled, signed on to the piggyback agreements.

The test cases proceeded to a consolidated one-month trial before the Tax Court sitting in Honolulu. The Tax Court ultimately concluded that the taxpayers were liable for all assessed deficiencies and would be required to pay additional negligence and tax-motivated transaction penalties. Crucial to this determination was the testimony of John R. Thompson ("Thompson"), the only taxpayer who testified that he believed the instruments creating the claimed interest would not be enforced.

As it turns out, that which the Tax Court and other participants believed to be a legitimate, representative proceeding, binding on the test case petitioners and all those waiting in the wings, was anything but. Some time prior to the test case trial, Kenneth W. McWade ("McWade"), the IRS attorney trying the case, and William A. Sims ("Sims"), the IRS attorney with supervisory authority over it, had entered into secret settlement agreements with Thompson and another test case petitioner, John R. Cravens ("Cravens"). Cravens was one of the taxpayer-selected test case representatives, chosen by taxpayer counsel because his payment of capital gains taxes upon exiting the Kersting investment program made him a particularly good representative.

A condition of their settlements required Thompson and Cravens to remain test case petitioners. McWade also convinced Cravens, who mistakenly believed his liability was finalized by the settlement, to proceed *pro se*. With respect to Thompson,[4] McWade agreed to have Thompson's tax deficiencies reduced in proportion to his attorney's fees, which exceeded $60,000. At no point did McWade or Sims reveal to the Tax Court or to any other taxpayer representative that two of the test case petitioners' cases had been settled, much less reveal the conditions imposed on them.

The deception continued with a cover-up, which was carefully designed to prevent the Tax Court and other taxpayers from learning of the secret settlement agreements. At Kersting's deposition, which McWade attended, Kersting's lawyer objected to the presence of Thompson's attorney because of rumors that Thompson was attempting to settle. Knowing that Thompson had, in fact, already settled, McWade remained silent. McWade then misled the Tax Court by failing to disclose the settlement when he moved to set aside the Thompson piggyback agreement, a pre-trial motion necessary to ensure Thompson's status as a test case petitioner.

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4. Thompson had an ongoing dispute with Kersting over the validity of the investment certificates. Specifically, Kersting had threatened to initiate collection proceedings against Thompson. Therefore, Thompson had an interest in seeing that the certificates of investment were declared invalid and unenforceable. DeCastro, Thompson's attorney, used the test case proceeding to elicit testimony from Thompson regarding the sham nature of the notes in order to bolster Thompson's position in any subsequent litigation with Kersting.

Appendix D

Deceptive silence matured into overt misconduct when, during the course of the test case trial, it became apparent that Thompson was going to testify about his settlement. McWade quickly shifted his questions to unrelated matters.[5]

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5. In the Tax Court proceedings on remand, Judge Beghe pointed to the following exchange as evidence of this deception:

> Mr. Thompson:
>
> The procedure went through a tax firm in Los Angeles known as Loeb & Loeb, and I wound up with the DeCastro Law Corporation by way of their direction, and made several discoveries that were startling to me. And of course, I settled. To be quite honest, I had to get out of this. I was not going to spend my life—
>
> Mr. McWade: Well, let me—
>
> Mr. Thompson: —doing all this.
>
> Mr. McWade: Let me stop you here for a moment.
>
> Mr. Thompson: Okay. I'm sorry. I beg your pardon.
>
> Mr. McWade: Mr. Thompson, can you tell me: have we been successful in getting the lien removed from your house?

Thompson's use of the word "settled" did not disclose the secret settlement between Thompson and the IRS because, in the original proceeding, Judge Goffe mistakenly interpreted the remark as referring to resolution of the Thompsons' tax liability for another year which was not at issue. *Dixon v. Comm'r*, 77 T.C.M. (CCH) 1630, n.55. McWade did nothing to disabuse the court of its interpretation.

McWade and Sims also secured an agreement with taxpayer Dennis Alexander[6] ("Alexander") whereby the IRS would reduce Alexander's tax deficiencies in exchange for testimony and trial preparation assistance. In accordance with this agreement, the IRS paid for Alexander's expenses in Hawaii for the length of the trial. McWade then filed a memorandum regarding the basis for the settlement of Alexander's tax liabilities which the Tax Court later found to be false. During the test case trial, McWade also sat silently through testimony by Alexander that he knew to be false.[7]

The Tax Court ultimately entered judgment against the remaining taxpayers—those who had signed on to the piggyback agreements—on the same adverse terms as in the test case resolution. This is when the McWade-Sims house of cards began to collapse. Thompson and Cravens, who had sat silent while the Tax Court entered judgment against them, pressured McWade and Sims to live up to the terms of their secret settlement agreements. It was

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6. Alexander was then embroiled in a legal battle with Kersting involving more than $4 million. Alexander's animus towards Kersting was made clear in a letter to the IRS ("When the Nazi knows that 1400 of his clients are going to be clobbered and that he will have the Criminal Investigative Division of the IRS coming down on him, I think he will be inclined to pay me my money.")

7. When one of the attorneys for the taxpayers asked Alexander if McWade had discussed a reduction of Alexander's tax deficiency in exchange for his testimony, Alexander responded, "Specifically, no." McWade failed to correct this patently false statement.

now clear that the IRS would have to move to set aside the Thompson and Cravens judgments; McWade and Sims were forced to reveal the secret settlements necessitating the Tax Court's entry of "revised" judgments in favor of Thompson and Cravens.

After being asked to approve the set aside motions, senior IRS officials determined that McWade and Sims had engaged in active misconduct and informed the Tax Court of the secret ettlements,[8] asking for an evidentiary hearing to determine the extent of the damage. The Tax Court refused to hold an evidentiary hearing and proceeded to enforce the terms of the Thompson and Cravens settlements. The taxpayers appealed the refusal to this Court, which remanded with instructions to hold an evidentiary hearing. *Dufresne v. Comm'r*, 26 F.3d 105 (9th Cir. 1994).

On remand, the Tax Court conducted the mandated evidentiary hearing. Incredibly, McWade's pattern of deception continued with his persistent denial that the Thompson settlement was a vehicle for paying Thompson's attorneys' fees and his testimony that the Thompson settlement was attributable to a separate transaction. After making extensive findings concerning the government's misconduct, the Tax Court surprisingly concluded that what had occurred was harmless error. While the bulk of the decision from the original test case

8. As the Tax Court proceeding on remand revealed, this disclosure was anything but complete, excluding, for example, the arrangement to "pay" (through a reduction in disallowed deductions) $60,000 to Thompson for his attorney fees.

proceeding was reinstated, the Tax Court did relieve the taxpayers of that portion of the original judgment which imposed increased interest penalties for negligence and "tax motivated transactions" and imposed costs and attorneys' fees on the IRS. From the Tax Court's refusal to vacate the adverse judgments against them, the taxpayers filed this timely appeal. We have jurisdiction pursuant to 26 U.S.C. § 2482.

STANDARD OF REVIEW

We review the Tax Court's refusal to grant a motion vacating a judgment on the basis of fraud on the court for abuse of discretion, *Abatti v. Comm'r*, 859 F.2d 115, 117 (9th Cir. 1988); *England v. Doyle*, 281 F.2d 304, 309 (9th Cir. 1960), mindful that only when this Court has a "definite and firm conviction that the Tax Court committed a clear error of judgment in the conclusion it reached" is reversal appropriate. *Abatti*, 859 F.2d at 117.

DISCUSSION

Courts possess the inherent power to vacate or amend a judgment obtained by fraud on the court, *Toscano v. CIR*, 441 F.2d 930, 933 (9th Cir. 1971), but that power is narrowly construed, applying only to fraud that defiles the court or is perpetrated by officers of the court. When we conclude that the integrity of the judicial process has been harmed, however, and the fraud rises to the level of "an unconscionable plan or scheme which is designed to improperly influence the court in its decisions," we not only can act, we should. *England*, 281 F.2d at 309; *Levander v.*

Prober, 180 F.3d 1114, 1119 (9th Cir. 1999); *Intermagnetics Am., Inc. v. China Int'l Trust and Inv. Corp.*, 926 F.2d 912, 916-17 (9th Cir. 1991).

Here, the factual findings of the Tax Court support the conclusion that a fraud, plainly designed to corrupt the legitimacy of the truth-seeking process, was perpetrated on the trial court by McWade and Sims. The Tax Court, however, applied the wrong law when it imposed a requirement that taxpayers show prejudice as a result of the misconduct. *Dixon v. Comm'r*, 77 T.C.M. (CCH) 1630 (1999).

Prejudice is not an element of fraud on the court. *Hazel-Atlas*, 322 U.S. at 238; *Pumphrey v. K.W. Thompson Tool Co.*, 62 F.3d 1128, 1132-33 (9th Cir. 1995).[9] Fraud on the court occurs when the misconduct harms the integrity of the judicial process, regardless of whether the opposing party is prejudiced. *Alexander v. Robertson*, 882 F.2d 421, 424 (9th Cir. 1989). Furthermore, the perpetrator of the

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9. The Seventh Circuit reached a contrary decision in *Drobny v. Commissioner*, 113 F.3d 670, 678-79 (7th Cir. 1997). *Drobny* distinguishes *Hazel- Atlas* by claiming that *Hazel-Atlas* involved the general equitable powers of the federal courts as opposed to those of the Tax Court. *Id.* at n.15. The Ninth Circuit, however, holds to the view that the application of the fraud on the court doctrine in the context of Tax Court cases is the same as applied in Article III courts. *Toscano*, 441 F.2d at 934; *see also* 24 ALR Fed. 697 (1975) ("The construction and application of the phrase [fraud on the court] in other federal courts, as well as its use in Rule 60(b), although not binding in Tax Court cases, have been considered helpful when it has been necessary to apply the phrase in regard to possible vacation of final Tax Court decisions.").

fraud should not be allowed to dispute the effectiveness of the fraud after the fact. *Hazel Atlas*, 322 U.S. at 247; *Pumphrey*, 62 F.3d at 1133. Because the Tax Court applied the wrong legal standard, it abused its discretion. *See Paulson v. City of San Diego*, 294 F.3d 1124, 1128 (9th Cir. 2002) (en banc).

As the Supreme Court observed more than fifty years ago, "[t]ruth needs no disguise." *Hazel-Atlas*, 322 U.S. at 247. There can be no question here but that the actions of McWade and Sims amounted to a fraud on both the taxpayers and the Tax Court. The Tax Court believed it was hearing a legitimate adversarial dispute when, in fact, the proceeding was a charade fraught with concealed motives, hidden payments, and false testimony. What did occur was clearly designed to defile the court itself, and there is no question that it was carried out by an officer of the court. *Toscano*, 441 F.2d at 933. Such fraud corrupts the adversarial nature of the proceeding, the integrity of witnesses, and the ability of the trial court to judge impartially. *See England*, 281 F.2d 304. This harm is noteworthy not only because it defiled the sanctity of the court and the confidence of all future litigants, but also because it violated the rights of the test case petitioners and the more than 1,300 taxpayers who agreed to be bound by the outcome of the Tax Court proceeding. *See Levander*, 180 F.3d at 1118 ("[T]ampering with the administration of justice in this manner involves far more than an injury to a single litigant. It is a wrong against the institutions set up to protect and safeguard the public."). As such, the taxpayers have clearly and convincingly demonstrated fraud on the court and are entitled to relief.

Appendix D

REMEDY

We have the inherent power to vacate the judgment of the Tax Court, fashion an appropriate remedy, *Chambers v. NASCO, Inc.*, 501 U.S. 32, 44-45 (1991); *Hazel-Atlas*, 322 U.S. at 250; *Fink v. Gomez*, 239 F.3d 989, 992 (9th Cir. 2001), and sanction a party or its lawyers for willful abuse of the judicial process, particularly when the party or its lawyers have intentionally practiced a fraud upon the court. *Levander*, 180 F.3d at 1119; *see also Gomez v. Vernon*, 255 F.3d 1118, 1133-34 (9th Cir. 2001). This power, however, is to be "exercised with restraint and discretion." *Roadway Express, Inc. v. Piper*, 447 U.S. 752, 765 (1980).

Here, it plainly would be unjust to remand for a new, third trial. The IRS had an opportunity to present its case fairly and properly. Instead its lawyers intentionally defrauded the Tax Court. The Tax Court had two opportunities to equitably resolve this situation and failed. Enormous amounts of time and judicial resources have been wasted. In addition, the IRS has done little to punish the misconduct[10] and even less to dissuade future abuse.

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10. McWade and Sims were both suspended for two weeks without pay and transferred out of the Honolulu division. Sims accepted this censure and was transferred to the San Francisco Regional Counsel Office, where he was assigned nonsupervisory duties. McWade retired from the IRS, choosing not to accept the terms of the proposed disciplinary action but keeping the $1,000 bonus earlier paid him for his performance in the original Tax Court proceedings. We note that counsel for the Hongsermeier test case petitioners recently filed a grievance against McWade and Sims with the attorneys' respective Bars.

The taxpayers should not be forced to endure another trial and the IRS should be sanctioned for this extreme misconduct.

Conversely, we will not enter judgment eradicating all tax liability of these taxpayers. Such an extreme sanction, while within the court's power, is not warranted under these facts. *See Chambers*, 501 U.S. at 45. Instead, we remand to the trial court with directions to enter judgment in favor of Appellants and all other taxpayers properly before this Court on terms equivalent to those provided in the settlement agreement with Thompson and the IRS.[11]

CONCLUSION

The judgment of the Tax Court is reversed with directions to set aside the decision in *Dixon v. Comm'r*, 62 T.C.M. (CCH) 1440,[12] and to enter judgment in favor of Appellants consistent with this opinion.

REVERSED AND REMANDED WITH DIRECTIONS.

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11. We leave to the Tax Court's discretion the fashioning of such judgments which, to the extent possible and practicable, should put these taxpayers in the same position as provided for in the Thompson settlement.

12. This is the judgment entered following the original Tax Court proceeding, which bound the remaining "piggyback" taxpayers. This judgment was reinstated, with modification, following the Tax Court proceeding on remand. *Dixon v. Comm'r*, 77 T.C.M. (CCH) 1630.

APPENDIX E — ORDER DENYING PETITION FOR REHEARING OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT, FILED DECEMBER 28, 2010

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 07-73822
Tax Ct. Nos. 17642-83
38965-84
35608-86
479-89
8070-90

NORMAN W. ADAIR; BARBARA L. ADAIR,

Petitioners - Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent -Appellee.

Appendix E

No. 07-73823
Tax Ct. No. 40159-84

GLORIA K. OWENS; TERRY D. OWENS,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 07-73825
Tax Ct. Nos. 4201-84
22783-85
30010-85

HOYT W. YOUNG; BARBARA D. YOUNG,

Petitioners - Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent - Appellee.

Appendix E

ORDER

Before: FERNANDEZ, KLEINFELD and CLIFTON, Circuit Judges.

Judge Clifton has voted to deny the petition for rehearing en banc, and Judges Fernandez and Kleinfeld so recommend.

The full court has been advised of the petition for rehearing en banc and no judge of the court has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing en banc, filed November 19, 2010, is DENIED.

APPENDIX F — 26 UNITED STATES CODE SECTION 6404 - ABATEMENTS

26 U.S.C. § 6404. Abatements

(a) General rule — The Secretary is authorized to abate the unpaid portion of the assessment of any tax or any liability in respect thereof, which —

(1) is excessive in amount, or

(2) is assessed after the expiration of the period of limitation properly applicable thereto, or

(3) is erroneously or illegally assessed.

(b) No claim for abatement of income, estate, and gift taxes — No claim for abatement shall be filed by a taxpayer in respect of any assessment of any tax imposed under subtitle A or B.

(c) Small tax balances — The Secretary is authorized to abate the unpaid portion of the assessment of any tax, or any liability in respect thereof, if the Secretary determines under uniform rules prescribed by the Secretary that the administration and collection costs involved would not warrant collection of the amount due.

(d) Assessments attributable to certain mathematical errors by Internal Revenue Service — In the case of an assessment of any tax imposed by chapter 1 attributable in whole or in part to a mathematical error described in section 6213(g)(2)(A), if the return was prepared by an officer or employee of the Internal Revenue Service acting

in his official capacity to provide assistance to taxpayers in the preparation of income tax returns, the Secretary is authorized to abate the assessment of all or any part of any interest on such deficiency for any period ending on or before the 30th day following the date of notice and demand by the Secretary for payment of the deficiency.

(e) Abatement of interest attributable to unreasonable errors and delays by Internal Revenue Service

(1) In general In the case of any assessment of interest on —

(A) any deficiency attributable in whole or in part to any unreasonable error or delay by an officer or employee of the Internal Revenue Service (acting in his official capacity) in performing a ministerial or managerial act, or

(B) any payment of any tax described in section 6212(a) to the extent that any unreasonable error or delay in such payment is attributable to such an officer or employee being erroneous or dilatory in performing a ministerial or managerial act, the Secretary may abate the assessment of all or any part of such interest for any period. For purposes of the preceding sentence, an error or delay shall be taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved, and after the Internal Revenue Service has contacted the taxpayer in writing with respect to such deficiency or payment.

(2) Interest abated with respect to erroneous refund check — The Secretary shall abate the assessment of all interest on any erroneous refund under section 6602 until the date demand for repayment is made, unless -

(A) the taxpayer (or a related party) has in any way caused such erroneous refund, or

(E) such erroneous refund exceeds $50,000.

(f) Abatement of any penalty or addition to tax attributable to erroneous written advice by the Internal Revenue Service

(1) In general — The Secretary shall abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the Internal Revenue Service, acting in such officer's or employee's official capacity.

(2) Limitations — Paragraph (1) shall apply only if -

(A) the written advice was reasonably relied upon by the taxpayer and was in response to a specific written request of the taxpayer, and

(B) the portion of the penalty or addition to tax did not result from a failure by the taxpayer to provide adequate or accurate information.

(3) Initial regulations — Within 180 days after the date of the enactment of this subsection, the Secretary shall

prescribe such initial regulations as may be necessary to carry out this subsection.

(g) Suspension of interest and certain penalties where Secretary fails to contact taxpayer

(1) Suspension

(A) In general — In the case of an individual who files a return of tax imposed by subtitle A for a taxable year on or before the due date for the return (including extensions), if the Secretary does not provide a notice to the taxpayer specifically stating the taxpayer's liability and the basis for the liability before the close of the 18-month period beginning on the later of —

(i) the date on which the return is filed; or

(ii) the due date of the return without regard to extensions,

the Secretary shall suspend the imposition of any interest, penalty, addition to tax, or additional amount with respect to any failure relating to the return which is computed by reference to the period of time the failure continues to exist and which is properly allocable to the suspension period.

(B) Separate application — This paragraph shall be applied separately with respect to each item or adjustment. If, after the return for a taxable year is filed, the taxpayer provides to the Secretary 1 or more signed

written documents showing that the taxpayer owes an additional amount of tax for the taxable year, clause (i) shall be applied by substituting the date the last of the documents was provided for the date on which the return is filed.

(2) Exceptions — Paragraph (1) shall not apply to -

(A) any penalty imposed by section 6651;

(B) any interest, penalty, addition to tax, or additional amount in a case involving fraud;

(C) any interest, penalty, addition to tax, or additional amount with respect to any tax liability shown on the return;

(D) any interest, penalty, addition to tax, or additional amount with respect to any gross misstatement;

(E) any interest, penalty, addition to tax, or additional amount with respect to any reportable transaction with respect to which the requirement of section 6664(d)(2)(A) is not met and any listed transaction (as defined in 6707A(c)); or

(F) any criminal penalty.

(3) Suspension period — For purposes of this subsection, the term "suspension period" means the period —

(A) beginning on the day after the close of the 18-month period under paragraph (1); and

(B) ending on the date which is 21 days after the date on which notice described in paragraph (1)(A) is provided by the Secretary.

(h) Review of denial of request for abatement of interest

(1) In general — The Tax Court shall have jurisdiction over any action brought by a taxpayer who meets the requirements referred to in section 7430(c)(4)(A)(ii) to determine whether the Secretary's failure to abate interest under this section was an abuse of discretion, and may order an abatement, if such action is brought within 180 days after the date of the mailing of the Secretary's final determination not to abate such interest.

(2) Special rules

(A) Date of mailing — Rules similar to the rules of section 6213 shall apply for purposes of determining the date of the mailing referred to in paragraph (1).

(B) Relief — Rules similar to the rules of section 6512(b) shall apply for purposes of this subsection.

(C) Review — An order of the Tax Court under this subsection shall be reviewable in the same manner as a decision of the Tax Court, but only with respect to the matters determined in such order.

Appendix F

(i) Cross reference — For authority to suspend running of interest, etc. by reason of Presidentially declared disaster or terroristic or military action, see section 7508A.

APPENDIX G — 26 UNITED STATES CODE SECTION 6601 - INTEREST ON UNDERPAYMENTS, NONPAYMENT, OR EXTENSIONS OF TIME FOR PAYMENT, OF TAX

26 U.S.C. § 6601. Interest on underpayment, nonpayment, or extensions of time for payment, of tax

(a) General rule If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or before the last date prescribed for payment, interest on such amount at the underpayment rate established under section 6621 shall be paid for the period from such last date to the date paid.

(b) Last date prescribed for payment For purposes of this section, the last date prescribed for payment of the tax shall be determined under chapter 62 with the application of the following rules:

(1) Extensions of time disregarded The last date prescribed for payment shall be determined without regard to any extension of time for payment or any installment agreement entered into under section 6159.

(2) Installment payments In the case of an election under section 6156(a) to pay the tax in installments —

(A) The date prescribed for payment of each installment of the tax shown on the return shall be determined under section 6156(b),[1] and

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1. See References in Text note below.

(B) The last date prescribed for payment of the first installment shall be deemed the last date prescribed for payment of any portion of the tax not shown on the return.

(3) Jeopardy — The last date prescribed for payment shall be determined without regard to any notice and demand for payment issued, by reason of jeopardy (as provided in chapter 70), prior to the last date otherwise prescribed for such payment.

(4) Accumulated earnings tax — In the case of the tax imposed by section 531 for any taxable year, the last date prescribed for payment shall be deemed to be the due date (without regard to extensions) for the return of tax imposed by subtitle A for such taxable year.

(5) Last date for payment not otherwise prescribed — In the case of taxes payable by stamp and in all other cases in which the last date for payment is not otherwise prescribed, the last date for payment shall be deemed to be the date the liability for tax arises (and in no event shall be later than the date notice and demand for the tax is made by the Secretary).

(c) Suspension of interest in certain income, estate, gift, and certain excise tax cases — In the case of a deficiency as defined in section 6211 (relating to income, estate, gift, and certain excise taxes), if a waiver of restrictions under section 6213(d) on the assessment of such deficiency has been filed, and if notice and demand by the Secretary for payment of such deficiency is not made within 30 days after the filing of such waiver,

interest shall not be imposed on such deficiency for the period beginning immediately after such 30th day and ending with the date of notice and demand and interest shall not be imposed during such period on any interest with respect to such deficiency for any prior period. In the case of a settlement under section 6224(c) which results in the conversion of partnership items to nonpartnership items pursuant to section 6231(b)(1)(C), the preceding sentence shall apply to a computational adjustment resulting from such settlement in the same manner as if such adjustment were a deficiency and such settlement were a waiver referred to in the preceding sentence.

(d) Income tax reduced by carryback or adjustment for certain unused deductions

(1) Net operating loss or capital loss carryback If the amount of any tax imposed by subtitle A is reduced by reason of a carryback of a net operating loss or net capital loss, such reduction in tax shall not affect the computation of interest under this section for the period ending with the filing date for the taxable year in which the net operating loss or net capital loss arises.

(2) Foreign tax credit carrybacks If any credit allowed for any taxable year is increased by reason of a carryback of tax paid or accrued to foreign countries or possessions of the United States, such increase shall not affect the computation of interest under this section for the period ending with the filing date for the taxable year in which such taxes were in fact paid or accrued, or, with respect

to any portion of such credit carryback from a taxable year attributable to a net operating loss carryback or a capital loss carryback from a subsequent taxable year, such increase shall not affect the computation of interest under this section for the period ending with the filing date for such subsequent taxable year.

(3) Certain credit carrybacks

(A) In general — If any credit allowed for any taxable year is increased by reason of a credit carryback, such increase shall not affect the computation of interest under this section for the period ending with the filing date for the taxable year in which the credit carryback arises, or, with respect to any portion of a credit carryback from a taxable year attributable to a net operating loss carryback, capital loss carryback, or other credit carryback from a subsequent taxable year, such increase shall not affect the computation of interest under this section for the period ending with the filing date for such subsequent taxable year.

(B) Credit carryback defined — For purposes of this paragraph, the term "credit carryback" has the meaning given such term by section 6511(d)(4)(C).

(4) Filing date — For purposes of this subsection, the term "filing date" has the meaning given to such term by section 6611(f)(3)(A).

(c) Applicable rules Except as otherwise provided in this title —

Appendix G

(1) Interest treated as tax — Interest prescribed under this section on any tax shall be paid upon notice and demand, and shall be assessed, collected, and paid in the same manner as taxes. Any reference to this title (except subchapter B of chapter 63, relating to deficiency procedures) to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax.

(2) Interest on penalties, additional amounts, or additions to the tax

(A) In general — Interest shall be imposed under subsection (a) in respect of any assessable penalty, additional amount, or addition to the tax (other than an addition to tax imposed under section 6651(a)(1) or 6653 or under part II of subchapter A of chapter 68) only if such assessable penalty, additional amount, or addition to the tax is not paid within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which such notice and demand is made equals or exceeds $100,000), and in such case interest shall be imposed only for the period from the date of the notice and demand to the date of payment.

(B) Interest on certain additions to tax Interest shall be imposed under this section with respect to any addition to tax imposed by section 6651(a)(1) or 6653 or under part II of subchapter A of chapter 68 for the period which —

(i) begins on the date on which the return of the tax with respect to which such addition to tax is imposed is required to be filed (including any extensions), and

(ii) ends on the date of payment of such addition to tax.

(3) Payments made within specified period after notice and demand — If notice and demand is made for payment of any amount and if such amount is paid within 21 calendar days (10 business days if the amount for which such notice and demand is made equals or exceeds $100,000) after the date of such notice and demand, interest under this section on the amount so paid shall not be imposed for the period after the date of such notice and demand.

(f) Satisfaction by credits — If any portion of a tax is satisfied by credit of an overpayment, then no interest shall be imposed under this section on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment. The preceding sentence shall not apply to the extent that section 6621(d) applies.

(g) Limitation on assessment and collection — Interest prescribed under this section on any tax may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected.

(h) Exception as to estimated tax — This section shall not apply to any failure to pay any estimated tax required to be paid by section 6654 or 6655.

(i) Exception as to Federal unemployment tax — This section shall not apply to any failure to make a payment of tax imposed by section 3301 for a calendar quarter or other period within a taxable year required under authority of section 6157.

(j) 2-percent rate on certain portion of estate tax extended under section 6166

(1) In general If the time for payment of an amount of tax imposed by chapter 11 is extended as provided in section 6166, then in lieu of the annual rate provided by subsection (a) —

(A) interest on the 2-percent portion of such amount shall be paid at the rate of 2 percent, and

(B) interest on so much of such amount as exceeds the 2-percent portion shall be paid at a rate equal to 45 percent of the annual rate provided by subsection (a).

For purposes of this subsection, the amount of any deficiency which is prorated to installments payable under section 6166 shall be treated as an amount of tax payable in installments under such section.

(2) 2-percent portion For purposes of this subsection, the term "2-percent portion" means the lesser of —

(A) (i) the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the sum of $1,000,000 and the applicable exclusion amount in effect under section 2010(c), reduced by

(ii) the applicable credit amount in effect under section 2010(c), or

(B) the amount of the tax imposed by chapter 11 which is extended as provided in section 6166.

(3) Inflation adjustment — In the case of estates of decedents dying in a calendar year after 1998, the $1,000,000 amount contained in paragraph (2)(A) shall be increased by an amount equal to —

(A) $1,000,000, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "calendar year 1997" for "calendar year 1992" in subparagraph (B) thereof.

(4) Treatment of payments If the amount of tax imposed by chapter 11 which is extended as provided in section 6166 exceeds the 2-percent portion, any payment of a portion of such amount shall, for purposes of computing interest for periods after such payment, be treated as reducing the 2-percent portion by an amount which bears the same ratio to the amount of such payment as the amount of the 2-percent portion (determined without regard to this paragraph) bears to the amount of the tax which is extended as provided in section 6166.

(k) No interest on certain adjustments For provisions prohibiting interest on certain adjustments in tax, see section 6205(a).